

STATE OF NORTH CAROLINA  
COUNTY OF WAKE

BEFORE THE  
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Additional )  
Income Tax for the Taxable Year 1999 by )  
the Secretary of Revenue of North Carolina )  
vs. )  
[Taxpayers] )

**FINAL DECISION**  
Docket No. 2001-24

This matter was heard before the Acting Assistant Secretary of Administrative Hearings, Marilyn R. Mudge, in the city of Raleigh on March 21, 2001, upon an application for hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessment of additional income tax for the taxable year 1999. The hearing was held under the provisions of G.S. 105-260.1 and was attended by Husband; Gregory B. Radford, Assistant Director of the Personal Taxes Division; Angela C. Quinn, Administrative Officer in the Personal Taxes Division; and, with Husband's permission and at his request, [an acquaintance] of Taxpayers.

Pursuant to G.S. 105-241.1, an assessment proposing additional tax, a twenty-five percent negligence penalty, and accrued interest totaling \$1,852.72 for the tax year 1999 was mailed to Taxpayers on August 23, 2000. Taxpayers filed a timely protest to the proposed assessment and requested a hearing before the Secretary of Revenue.

**ISSUE**

The issue to be decided in this matter is as follows:

Is the assessment for additional income tax proposed against Taxpayers for the taxable year 1999 lawful and proper?

## EVIDENCE

The evidence presented by Gregory B. Radford, Assistant Director of the Personal Taxes Division, consisted of the following:

1. Memorandum from E. Norris Tolson, Secretary of Revenue, to Marilyn R. Mudge, Acting Assistant Secretary of Administrative Hearings, dated March 13, 2001, a copy of which is designated as Exhibit PT-1.
2. Taxpayers' North Carolina individual income tax return for the taxable year 1999 with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1999 dated August 23, 2000, a copy of which is designated as Exhibit PT-3.
4. Husband's wage earnings information from the Employment Security Commission dated August 11, 2000, a copy of which is designated as Exhibit PT-4.
5. Wife's wage earnings information from the Employment Security Commission dated August 11, 2000, a copy of which is designated as Exhibit PT-5.
6. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1999, a copy of which is designated as Exhibit PT-6.
7. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1998, a copy of which is designated as Exhibit PT-7.
8. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1997, a copy of which is designated as Exhibit PT-8.
9. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1996, a copy of which is designated as Exhibit PT-9.
10. Letter from Husband to Muriel K. Offerman, former Secretary of Revenue, dated September 19, 2000, a copy of which is designated as Exhibit PT-10.
11. Letter from Gregory B. Radford to Taxpayers dated October 12, 2000, a copy of which is designated as Exhibit PT-11.
12. Letter from Husband to Gregory B. Radford dated November 6, 2000 with related attachments, copies of which are collectively designated as Exhibit PT-12.

13. Letter from Husband to Muriel K. Offerman dated November 6, 2000, a copy of which is designated as Exhibit PT-13.
14. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Taxpayers dated November 20, 2000, a copy of which is designated as Exhibit PT-14.
15. Letter from Husband to Michael A. Hannah dated December 4, 2000, a copy of which is designated as Exhibit PT-15.
16. Letter from Husband to Muriel K. Offerman dated January 16, 2001, a copy of which is designated as Exhibit PT-16.
17. Letter from Gregory B. Radford to Taxpayers dated February 8, 2001, a copy of which is designated as Exhibit PT-17.
18. Letter from Sabra J. Faires, Assistant Secretary of Revenue, to Taxpayers dated February 23, 2001, a copy of which is designated as Exhibit PT-18.
19. Letter from Marilyn R. Mudge to Taxpayers dated February 28, 2001, a copy of which is designated as Exhibit PT-19.

The evidence presented by Husband at the hearing consisted of the following:

1. Response to Tax Brief, a copy of which is designated as Exhibit TP-1.
2. Sections 11 and 22 of the 1939 Internal Revenue Code and sections 1 and 61 of the 1954 Internal Revenue Code, copies of which are designated as Exhibit TP-2.
3. Irwin Schiff's Tax Freedom Testimonials, a copy of which is designated as Exhibit TP-3.
4. Form containing Affidavit of Claim of Exemption From Personal State Income Taxes and Affidavit of Points and Authorities, a copy of which is designated as Exhibit TP-4.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Acting Assistant Secretary makes the following findings of fact:

1. Taxpayers are and at all material times were natural persons, sui juris, and citizens and residents of North Carolina.
2. Taxpayers timely filed their North Carolina income tax return for the tax year 1999.
3. Taxpayers' 1999 return reflected federal taxable income of zero, North Carolina income tax of zero, and North Carolina tax withheld of \$1,616.00. Taxpayers did not request a refund on the return.

4. Wage history information from the Employment Security Commission shows that Husband had wages of at least \$26,250.00 and that Wife had wages of at least \$5,664.00 during the tax year 1999. Information from federal tax return detail reports for earlier tax years shows that Taxpayers, in addition to wages, earned income from business activities. In 1998, the net profit was \$23,419.00. In 1997, insufficient information is available to identify the other sources of income but gross income other than wages was at least \$43,428.00. In 1996, the net profit was \$31,242.00. From that information, the Department estimated net profit from business activities of \$27,330.00 for 1999.
5. Upon examination, the Department calculated Taxpayers' federal taxable income to be \$43,794.00, consisting of wages of \$31,914.00 based on the Employment Security Commission reports; estimated business income of \$27,330.00; the standard deduction for a married couple filing jointly; and two personal exemptions.
6. North Carolina taxable income was determined to be \$46,744.00 by increasing federal taxable income by \$2,200.00 for the difference between the amount allowed for the federal standard deduction and the State standard deduction and by \$750.00 for the difference between the amount allowed for the federal personal exemption and the State personal exemption.
7. A Notice of Individual Income Tax Assessment proposing an assessment of additional income tax, a twenty-five percent negligence penalty, and accrued interest totaling \$1,852.72 was mailed to Taxpayers on August 23, 2000.
8. Taxpayers objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
9. Subsequent to the proposed assessment, federal tax return detail for the tax year 1999 was received from the Internal Revenue Service. The report shows that federal records reflect wages of \$37,706.00, \$5,792.00 more than reflected in the Employment Security Commission reports.

### **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Acting Assistant Secretary makes the following conclusions of law:

1. It is the duty of the North Carolina Department of Revenue to collect taxes due to the State.
2. North Carolina imposes an individual income tax upon the taxable income of (1) every resident of this State and (2) every nonresident individual deriving income from North Carolina sources attributable to the ownership of any interest in real or tangible personal property in this State or deriving income from a business, trade, profession, or occupation carried on in this State.
3. "Taxpayer" is defined as an individual subject to the individual income tax. "Individual" is defined as a human being.

4. For residents of this State, "North Carolina taxable income" is the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted as statutorily mandated for differences in State and federal law.
5. Federal taxable income is defined by the Internal Revenue Code as gross income less deductions and personal exemptions. Gross income is defined as all income from whatever source derived unless specifically excepted. Gross income includes compensation for services rendered and gross income derived from business. Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, tips, and bonuses are all includable in gross income.
6. Additions to federal taxable income are required for the amount by which the taxpayer's standard deduction has been increased and the amount by which each of the taxpayer's personal exemptions has been increased for inflation under the Code. The increase in the personal exemption for inflation is reduced by \$500.00 if the taxpayer's federal adjusted gross income is below the threshold for the taxpayer's filing status. Additions of \$2,950.00 were properly made for the tax year 1999.
7. An individual is required to file a federal income tax return if his gross income for the year equals or exceeds the allowable exemption amount.
8. A resident of this State is required to file a North Carolina individual income tax return if the individual is required to file a federal income tax return. The North Carolina return shall show the taxable income and adjustments to federal taxable income required by statute. The Secretary of Revenue may require a taxpayer to verify any information on the taxpayer's individual income tax return. An income tax return shall be filed as prescribed by the Secretary. The return shall be in the form prescribed by the Secretary. Form D-400 and Form D-400EZ are the forms prescribed by the Department of Revenue as the proper forms for individual income taxpayers to file.
9. The Secretary of Revenue may require a taxpayer to file a supplementary return if the Secretary believes that the taxpayer has failed to include taxable income on the return. The Secretary may proceed to propose an assessment of tax or additional tax whether or not a supplementary return is required.
10. The Secretary of Revenue has the power to examine any books, papers, records, or other relevant data for the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the tax liability of a person, or collecting any such tax.
11. If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer is required to file a return with the Secretary of Revenue reflecting the corrected or determined taxable income.
12. If the taxpayer does not provide adequate and reliable information upon which to compute his tax liability, an assessment may be made upon the basis of the best information

available; and, in the absence of information to the contrary, such assessment is deemed to be correct. Assessments must generally be proposed within three years of the date the return was filed or the date the return was due to be filed, whichever is later.

13. A twenty-five percent negligence penalty is imposed for a large individual income tax deficiency. A large income tax deficiency exists when a taxpayer understates taxable income by an amount equal to twenty-five percent or more of gross income. A penalty of \$360.50 was properly assessed for the tax year 1999 because Taxpayers understated taxable income by 70% of gross income.
14. The Secretary of Revenue's duties include administering the laws enacted by the General Assembly relating to the assessment and collection of individual income taxes. As an official of the executive branch of the government, the Secretary lacks the authority to determine the constitutionality of legislative acts. The question of constitutionality of a statute is for the judicial branch.
15. The proposed assessment for the tax year 1999 is lawful and proper based on the best information available except that North Carolina taxable income reflected in the proposed assessment must be increased by \$5,792.00 for the difference in the amount of wages included in the information received from the Internal Revenue Service and the amount of wages used in the Department's calculation of federal taxable income.

### **DECISION**

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Acting Assistant Secretary of Administrative Hearings finds the proposed assessment for the tax year 1999, to the extent hereinafter modified, to be lawful and proper and is hereby affirmed.

Taxpayers present many arguments in defense of their position that the assessment is in error. These arguments have been made on many occasions both before the courts and in previous administrative tax hearings by taxpayers who object to the payment of income tax. The arguments include (1) Taxpayers earned no income; (2) the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return; (3) no statute authorizes the Internal Revenue Service or North Carolina Department of Revenue to change their return; (4) the Secretary of Revenue is the only individual that has the statutory authority to make a proposed assessment of North Carolina income tax; and (5) income tax is

voluntary and taxpayers are the only ones who can “self-assess” the tax. I concur with the Final Decisions rendered in previous administrative tax hearings (see Final Decisions for Docket Nos. 2000-340 and 2000-370) and find that the Department’s Brief for Tax Hearing adequately addresses those arguments.

Taxpayers also present two other arguments that I will more fully address. Those arguments are: (1) the enactment of the Internal Revenue Code of 1954 resulted in salaries, wages, and compensation for personal services no longer being gross income; and (2) as citizens of the United States, none of the sources of income identified in Code section 861 and its accompanying regulations apply to Taxpayers; therefore, they did not receive “income from whatever source derived.”

Taxpayers are correct in their claim that the Internal Revenue Code of 1939 specifically provided that gross income includes “income derived from salaries, wages, or compensation for personal service” while section 61 of the Internal Revenue Code of 1954 no longer specifically includes salaries and wages in the listed items of income. Taxpayers assert that the deletion of those terms indicates Congress’ intent to no longer subject salaries and wages to the income tax. However, the regulations for Code section 61 and innumerable court cases completely overcome Taxpayers’ assertions. Pursuant to Regulation §1.61-2(a)(1), wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, tips, and bonuses are all includable in gross income. That regulation was proposed on November 2, 1956, and was adopted on November 25, 1957, subsequent to the enactment of the Internal Revenue Code of 1954. The courts have consistently held that wages and other forms of compensation for services rendered are income. *See E. M. Lonsdale*, CA-10, 90-2 USTC ¶50,581, *H.H. McKinley*, DC Ohio, 92-2 USTC ¶50,509, *A. Ficalora*, CA-2, 85-1 USTC ¶9103, *C. Stelly*, CA-5, 85-2 USTC ¶9436,

*Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68 (7<sup>th</sup> Cir. 1986). There are many other cases that could be cited. Taxpayers can cite none that rule otherwise.

Taxpayers correctly state that Code section 61 defines gross income as all income from whatever source derived. Taxpayers then attempt to define “source” and contend that Code section 861 and its accompanying statutes indicate that they are not subject to income tax on their wages because, as citizens of the United States, they have no sources of income for purposes of the income tax. According to Taxpayers’ arguments, the only individuals subject to income tax on wages would be nonresident aliens. Such is not the case. For a citizen of the United States, the source of income is irrelevant. In *Glenshaw Glass Co.*, 348 U.S. 426, 55-1 USTC ¶9308, the court concluded that income tax is imposed on “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” with no restrictions as to “sources.” Regulation 1.1-1(b) provides that “in general, all citizens of the United States, wherever resident, and all resident alien individuals, are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.” In addition, the term “from whatever source derived” in Code section 61 is not intended to be restrictive; instead, it is intended to be all-encompassing. In *United States v. Buras*, 633 F.2d 1356, 1361 (9<sup>th</sup> Cir. 1980), the court stated “According to Buras, income must be derived from some source. ...[T]he Sixteenth Amendment is broad enough to grant Congress the power to collect an income tax regardless of the source of the taxpayer’s income.” In *Angstadt v. Internal Revenue Service*, 84 AFTR2d, 99-5455, 1999 WL 820866, the court stated “By the terms of the Sixteenth Amendment and section 61(a), ‘source’ is not to be a limitation on taxable income. Rather, income is to be taxed regardless of its source.”



Code section 861 itself provides that the income of most citizens is from sources within the United States. Section 861(a) lists items of gross income that are treated as income from sources within the United States. Item (3) is compensation for labor or personal services performed in the United States. Regulation 1.861-4(a)(1) states that “gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment...” In *Aiello v. Commissioner*, T.C. Memo 1995-40, the court stated “Apparently, petitioner believes that the only sources of income for purposes of section 61 are listed in section 861, that income from sources within the United States is taxed only to nonresident aliens and foreign corporations...Under section 61(a)(1) and (4), petitioner clearly is required to include his wages, tokens, and interest in gross income.”

The federal tax return detail information received by the Department of Revenue from the Internal Revenue Service reflects wages in excess of the estimated amount of wages used in the proposed assessment. The proposed assessment of income tax, penalty, and interest for the tax year 1999, modified to increase North Carolina taxable income by the additional wages reflected in the federal information and to make corresponding changes in the amount of penalty and interest due as a result of the increased tax, is found to be lawful and proper in every respect and is hereby determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 3<sup>rd</sup> day of May, 2001.

Signature \_\_\_\_\_

Marilyn R. Mudge  
Acting Assistant Secretary of Administrative Hearings