

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessments of Additional)
Income Tax for the Taxable Years 1985)
through 1992 by the Secretary of Revenue)
of North Carolina)

vs.)

[Taxpayer])

FINAL DECISION
Docket No. 2002-137

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on May 23, 2002, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessments of additional income tax for the taxable years 1985 through 1992. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer and Nancy R. Pomeranz, Director of the Personal Taxes Division.

Pursuant to G.S. 105-241.1, assessments proposing additional tax, penalties, and interest for the tax years 1991 and 1992 were mailed to Taxpayer on January 13, 2001. Assessments proposing additional tax, penalties, and interest for the tax years 1985, 1986, 1987, 1988, 1989, and 1990 were mailed to Taxpayer on April 17, 2001. Taxpayer filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

The proposed assessments for the tax years 1991 and 1992 were subsequently amended to allow credit for State income tax withheld. Amended assessments for the tax years 1991 and 1992 were mailed to Taxpayer on April 17, 2001.

ISSUE

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

Are the assessments for additional income tax proposed against Taxpayer for the taxable years 1985, 1986, 1987, 1988, 1989, 1990, and 1992 lawful and proper?

EVIDENCE

The evidence presented by Nancy R. Pomeranz, Director of the Personal Taxes Division, consisted of the following:

1. Memorandum from E. Norris Tolson, Secretary of Revenue, to Eugene J. Cella, Assistant Secretary of Administrative Hearings, dated May 16, 2001, a copy of which is designated as Exhibit PT-1.
2. Notice of Individual Income Tax Assessment for the taxable year 1985 dated April 17, 2001, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1986 dated April 17, 2001, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1987 dated April 17, 2001, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1988 dated April 17, 2001, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 1989 dated April 17, 2001, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for the taxable year 1990 dated April 17, 2001, a copy of which is designated as Exhibit PT-7.
8. Notice of Individual Income Tax Assessment for the taxable year 1991 dated January 13, 2001, a copy of which is designated as Exhibit PT-8.
9. Notice of Amended Individual Income Tax Assessment for the taxable year 1991 dated April 17, 2001, a copy of which is designated as Exhibit PT-9.
10. Notice of Individual Income Tax Assessment for the taxable year 1992 dated January 13, 2001, a copy of which is designated as Exhibit PT-10.
11. Notice of Amended Individual Income Tax Assessment for the taxable year 1992 dated April 17, 2001, a copy of which is designated as Exhibit PT-11.
12. Internal Revenue Service Report of Income Tax Changes for taxable years 1985 through 1990, a copy of which is designated as Exhibit PT-12.
13. Internal Revenue Service Report of Income and Deduction Amounts Adjusted for taxable year 1991 dated July 12, 1993, a copy of which is designated as Exhibit PT-13.
14. Internal Revenue Service Report of Income Tax Examination Changes dated August 12, 1994, a copy of which is designated as Exhibit PT-14.
15. Letter from Nathan E. Pipkin, Jr. Revenue Field Auditor, to Taxpayer dated September 5, 2000, a copy of which is designated as Exhibit PT-15.

16. Letter from Taxpayer to Nathan E. Pipkin, Jr. dated January 8, 2001, a copy of which is designated as Exhibit PT-16.
17. Letter from Taxpayer to Secretary of Revenue dated January 6, 2001, with related attachments, copies of which are collectively designated as Exhibit PT-17.
18. Letter from Gregory B. Radford, Assistant Director of the Personal Taxes Division, to Taxpayer dated February 15, 2001, a copy of which is designated as Exhibit PT-18.
19. Letter from Nathan E. Pipkin, Jr. to Taxpayer dated February 21, 2001, a copy of which is designated as Exhibit PT-19.
20. Letter from Taxpayer to Nathan E. Pipkin, Jr. dated March 20, 2001, with related attachments, copies of which are collectively designated as Exhibit PT-20.
21. Letter from [an attorney] to Nancy R. Pomeranz, Director of the Personal Taxes Division, dated May 24, 2001, with related attachments, copies of which are collectively designated as Exhibit PT-21.
22. Letter from Gregory B. Radford to [an attorney] dated May 30, 2001, a copy of which is designated as Exhibit PT-22.
23. Letter from [an attorney] to Nancy R. Pomeranz dated June 25, 2001, a copy of which is designated as Exhibit PT-23.
24. Letter from Gregory B. Radford to [an attorney] dated June 27, 2001, a copy of which is designated as Exhibit PT-24.
25. Letter from [an attorney] to Nancy R. Pomeranz dated September 24, 2001, a copy of which is designated as Exhibit PT-25.
26. Letter from [an attorney] to Patrick G. Penny, Administrative Officer in the Personal Taxes Division, dated October 5, 2001, with related attachments, copies of which are collectively designated as Exhibit PT-26.
27. Facsimile from [an attorney] to Patrick G. Penny dated October 11, 2001, with related attachment, copies of which are collectively designated as Exhibit PT-27.
28. Letter from Patrick G. Penny to [an attorney] dated October 12, 2001, a copy of which is designated as Exhibit PT-28.
29. Letter from Patrick G. Penny to Taxpayer dated November 16, 2001, a copy of which is designated as Exhibit PT-29.
30. Facsimile from Taxpayer to Patrick G. Penny dated January 25, 2002, with related attachments, copies of which are collectively designated as Exhibit PT-30.
31. Letter from Eugene J. Cella to Taxpayer dated February 5, 2002, a copy of which is designated as Exhibit PT-31.

32. Letter from Eugene J. Cella to Taxpayer dated April 24, 2002, a copy of which is designated as Exhibit PT-32.

Taxpayer presented the following evidence at the hearing:

1. Screenprint from the Department of Revenue's website entitled Notice of Assessment, a copy of which is designated as Exhibit TP-1.
2. Excerpts from Chapter 16 of Session I and Chapter 323 of Session II of the Sixty-Third Congress, a copy of which is designated as Exhibit TP-2.
3. Facts of [Taxpayer], a copy of which is designated as Exhibit TP-3.
4. Withholding Exhibits, a copy of which is designated as Exhibit TP-4.

At the conclusion of the hearing, the Assistant Secretary allowed Taxpayer until June 6, 2002, to submit additional information for the record in support of his objection to the proposed assessments. The Assistant Secretary enters into the record a letter from Taxpayer to Eugene J. Cella dated June 5, 2002, a copy of which is designated as Exhibit TP-5.

FINDINGS OF FACT

1. Taxpayer is and at all material times was a natural person, sui juris, and a citizen and resident of North Carolina.
2. Taxpayer did not file North Carolina or federal individual income tax returns for the tax years 1985 through 1992.
3. The Department of Revenue received reports from the Internal Revenue Service listing Taxpayer's unreported income of \$50,798.00 for the tax year 1985; \$47,189.00 for the tax year 1986; \$37,829.00 for the tax year 1987; and \$45,809.00 for the tax year 1988. Reports were also received from the Internal Revenue Service indicating that the Internal Revenue Service had determined Taxpayer's federal taxable income to be \$39,796.00 for the tax year 1989; \$36,014.00 for the tax year 1990; \$66,521.00 for the tax year 1991; and \$171,790.00 for the tax year 1992. The federal taxable income amounts were determined by allowing the standard deduction for the filing status of single and one personal exemption.
4. Upon examination, the Department determined Taxpayer's North Carolina taxable income for the tax years 1985, 1986, 1987, and 1988 to be \$48,048.00, \$44,439.00, \$35,079.00, and \$43,059.00, respectively, by subtracting the North Carolina standard deduction amount (\$550.00 for each year) and the North Carolina personal exemption amount (\$2,200.00 for each year) from the unreported income listed in the federal report. The Department determined Taxpayer's North Carolina taxable income for the tax years 1989, 1990, 1991, and 1992 to be \$39,896.00, \$36,314.00, \$67,071.00, and \$172,516.00, respectively, by increasing Taxpayer's federal taxable income as reported by the Internal Revenue Service for the differences between the State and federal standard deduction and personal exemption allowances.

5. Pursuant to G.S. 105-241.1, Notices of Individual Income Tax Assessment reflecting additional tax, penalties, and interest for the tax years 1991 and 1992 were mailed to Taxpayer on January 13, 2001. Notices of Individual Income Tax Assessment reflecting additional tax, penalties, and interest for the tax years 1985 through 1990 were mailed to Taxpayer on April 17, 2001. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
6. Taxpayer provided the examining auditor with some payroll stubs from each of the years at issue that reflected North Carolina income tax withheld from Taxpayer's regular pay. State income tax withheld was estimated for each year based on the payroll stubs provided and Taxpayer was given credit for the estimated amounts on the initial proposed assessments for the tax years 1985 through 1990. For the tax years 1991 and 1992, the original assessments were adjusted to allow Taxpayer credit for the estimated State income tax withheld. Notices of Amended Individual Income Tax Assessment reflecting the amended additional tax, penalties, and interest for the tax years 1991 and 1992 were mailed to Taxpayer on April 17, 2001.
7. Taxpayer understated taxable income by more than twenty-five percent of gross income for each of the years in question.
8. Taxpayer received a separation payment of \$115,000.00 subject to North Carolina income tax from [a railroad company] in 1992.
9. Subsequent to receiving the hearing request, Taxpayer provided documentation to substantiate that North Carolina income taxes of \$8,050.00 were withheld from the separation payment of \$115,000.00 Taxpayer received in 1992.
10. Subsequent to receiving the hearing request, wages for the tax year 1991 were determined to be less than the amount shown on the federal report based on the November 27, 1991 payroll stub from [a railroad company] provided by Taxpayer. After adjusting the 1991 account to reflect the decrease in wages, the 1991 proposed assessment was withdrawn because Taxpayer owed no additional tax.
11. Taxpayer contends that (1) the income tax is a non-apportioned direct tax in violation of the United States Constitution; (2) the income tax applies only to government employees; (3) the income tax applies only to people who have obtained privileges, licenses, or franchises from either the federal or State governments; (4) Taxpayer is a "non-taxpayer" and therefore is not subject to any of the Revenue laws of North Carolina; (5) the Department of Revenue did not issue the assessments timely.

CONCLUSIONS OF LAW

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

1. A resident of North Carolina is an individual who is domiciled in this State at any time during the taxable year or who resides in this State during the taxable year for other than a temporary or transitory purpose.

2. For taxable years prior to 1989, the North Carolina General Statutes imposed an individual income tax upon the net income in excess of the exemptions allowed 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. "Net income" was defined as the gross income of a taxpayer, less the deductions allowed by Division II of Article 4 in Chapter 105. Except for certain specified exclusions, "gross income" was defined as all income in whatever form and from whatever source derived.
3. For taxable years prior to 1989, a taxpayer was required to file a North Carolina income tax return specifically showing items of gross income and deductions when the gross income of the taxpayer exceeded his basic personal exemption.
4. For taxable years after 1988, the North Carolina General Statutes impose 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. For residents of this State, "North Carolina taxable income" is defined as 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 in 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. 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.
7. For taxable years after 1988, 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 must show the taxable income and adjustments to federal taxable income required by statute.
8. For taxable years after 1988, additions to federal taxable income are required for the amount by which a taxpayer's standard deduction has been increased for inflation and the amount by which each of a taxpayer's personal exemptions has been increased for inflation. Additions of \$100.00, \$300.00, \$550.00, and \$726.00 were properly made for the tax years 1989, 1990, 1991, and 1992, respectively.
9. 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.
10. If a 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.

11. 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 the later. When a return has not been filed, there is no statute of limitations and an assessment can be proposed at any time.
12. A penalty is imposed for failure to file a return when due. The penalty is equal to five percent of the tax for each month, or fraction of a month, the return is late (minimum \$5.00, maximum twenty-five percent). Penalties of \$42.01, \$71.23, \$50.28, \$98.85, \$243.53, and \$7.86 were properly assessed for the years 1985, 1986, 1987, 1988, 1989, and 1990, respectively. The penalty for the tax year 1992 must be reduced to \$315.76 to recognize the reduction in tax liability by allowing additional credit of \$8,050.00 for North Carolina income tax withheld.
13. A penalty is imposed for failure to pay tax when due. The penalty is equal to ten percent of the tax (minimum \$5.00). Penalties of \$16.81, \$28.49, \$20.11, \$39.54, \$97.41, and \$5.00 were properly assessed for the years 1985, 1986, 1987, 1988, 1989, and 1990, respectively. The penalty for the tax year 1992 must be reduced to \$126.30 to recognize the reduction in tax liability by allowing additional credit of \$8,050.00 for North Carolina income tax withheld.
14. 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. Penalties of \$42.01, \$71.23, \$50.28, \$98.85, \$243.53, and \$7.86 were properly assessed for the years 1985, 1986, 1987, 1988, 1989, and 1990, respectively. The penalty for the tax year 1992 must be reduced to \$315.76 to recognize the reduction in tax liability by allowing additional credit of \$8,050.00 for North Carolina income tax withheld.
15. 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. The constitutionality of the income tax statutes is not within the Secretary's jurisdiction.
16. The proposed assessments for the tax years 1985, 1986, 1987, 1988, 1989, 1990, and 1992 are lawful and proper based on the best information available except that for the tax year 1992, additional credit of \$8,050.00 must be allowed for North Carolina income tax withheld by Taxpayer's employer on the \$115,000.00 separation payment; and the penalties for failure to file, failure to pay, and negligence must be calculated on the corrected additional tax liability after allowing the additional credit for income tax withheld.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessments for the tax years 1985, 1986, 1987, 1988, 1989, 1990, and the proposed assessment for the tax year 1992, to the extent hereinafter modified, to be lawful and proper and are hereby affirmed.

Taxpayer presents many arguments in defense of his position that the assessments are 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 have consistently and uniformly been found to be completely lacking in legal merit and patently frivolous. Taxpayer's arguments include (1) the income tax is a non-apportioned direct tax in violation of the United States Constitution; (2) the income tax applies only to government employees; (3) the income tax applies only to people who have obtained privileges, licenses, or franchises from either the federal or State governments; (4) Taxpayer is a "non-taxpayer" and therefore is not subject to any of the Revenue laws of North Carolina; (5) the Department of Revenue did not issue the assessments timely.

Taxpayer contends that the income tax is a non-apportioned direct tax in violation of the United States Constitution. In *Ficalora v. Commissioner*, 751 F.2d 85, 85-1 USTC (CCH) ¶9103 (1984), the Court held that Congress had the Constitutional authority to impose an income tax on individuals. The Court cited the United States Supreme Court's decision in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429, 15 S. Ct. 673, rehearing 158 U.S. 601, 15 S. Ct. 912 (1895), which explicitly stated that taxes on income from employment were not direct taxes and were not subject to the necessity of apportionment. Furthermore, the Sixteenth Amendment granted Congress the power to lay and collect taxes on income, from whatever source derived, without apportionment. In *United States v. Gerads*, 999 F.2d 1255, 72 A.F.T.R.2d (RIA) 5506 (8th Cir. 1993), the Court stated "we have rejected, on numerous

occasions, the tax-protestor argument that the federal income tax is an unconstitutional direct tax that must be apportioned.”

Taxpayer contends that the income tax applies only to government employees. This argument is based on an apparent misinterpretation of section 3401 of the Internal Revenue Code, which imposes responsibilities to withhold tax from “wages.” That section establishes the general rule that “wages” include all remuneration for services performed by an employee for his employer. Code section 3401(c) states that “for purposes of this chapter, the term ‘employee’ includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.” Code section 7701(c) states that the use of the word “includes” “shall not be deemed to exclude other things otherwise within the meaning of the term defined.” Thus, the word “includes” as used in the definition of “employee” is a term of enlargement, not of limitation. It clearly makes federal and state employees and officials a part of the definition of “employee,” which generally includes private citizens.

Taxpayer also argues that the income tax applies only to people who have obtained privileges, licenses, or franchises from either the federal or State governments. Section 61 of the Internal Revenue Code imposes a tax on all income. The notion that taxation of income is an excise tax and can only be imposed on the exercise of a privilege has been consistently rejected by the courts. In *Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68, 70 (7th Cir. 1986), the Court held that “...Holder, who styles himself a ‘private citizen,’ insists that wages may not be taxed because the Sixteenth Amendment authorizes only excise taxes, and in Holder’s world excises may be imposed only on ‘government granted privileges.’ Because Holder believes that he is exercising no special privileges, he thinks he may not be taxed. These are tired arguments. The code imposes a tax on all income. See U.S.C. § 61. Wages are income, and the tax on wages is constitutional.” In *Olson v. United States*, 760 F.2d 1003, 1005 (9th Cir. 1985), the Court states, “Furthermore, Olson’s attempt to escape tax by deducting

his wages as 'cost of labor' and by claiming that he had obtained no privilege from a governmental agency illustrates the frivolous nature of his position. This court has repeatedly rejected the argument that wages are not income as frivolous, [citations omitted] and has also rejected the idea that a person is liable for tax only if he benefits from a governmental privilege.”

Taxpayer contends that he is a “non-taxpayer” and therefore is not subject to any of the revenue laws of North Carolina. This contention is totally without arguable merit. Taxpayer is obviously a human being and, as a resident of North Carolina, he is subject to North Carolina income tax.

Taxpayer contends that the assessments are invalid since the Department did not issue the assessments timely. In general, North Carolina law provides that the Department of Revenue has three years from the due date of the return or the date the taxpayer actually files the return, whichever is later, to propose an assessment of any tax due. North Carolina law also allows the Department three years from the date the Internal Revenue Service notifies the Department of changes made to a taxpayer's return to propose an assessment for any additional tax due. There is no statute of limitations and the Secretary may propose an assessment of tax due from a taxpayer at any time if the taxpayer does not file a return. Since Taxpayer did not file returns for the tax years at issue, I find that the income tax assessments proposed by the Department were indeed issued timely and are valid.

Therefore, the proposed assessments for the tax years 1985, 1986, 1987, 1988, 1989, 1990, and 1992, modified to allow additional credit for North Carolina income tax withheld of \$8,050.00 and to make corresponding changes in the amount of penalty and interest due as a result of the amended tax, are found to be lawful and proper in every respect and are hereby determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 17th day of July, 2002.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue