

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 2000 by)
the Secretary of Revenue of North Carolina)

vs.)

[Taxpayers])

FINAL DECISION
Docket No. 2002-228

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on June 24, 2002, upon an application for hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessment of additional income tax for the taxable year 2000. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayers and Nancy R. Pomeranz, Director of the Personal Taxes Division.

Pursuant to G.S. 105-241.1, an assessment proposing additional tax, a frivolous return penalty, and accrued interest totaling \$593.22 for the tax year 2000 was mailed to Taxpayers on December 13, 2001. 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 2000 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. Taxpayers' North Carolina individual income tax return for the taxable year 2000 with related attachments, copies of which are collectively designated as Exhibit PT-2.

3. Notice of Individual Income Tax Assessment for the taxable year 2000 dated December 13, 2001, a copy of which is designated as Exhibit PT-3.
4. Husband's wage earnings information from the Employment Security Commission dated February 22, 2002, a copy of which is designated as Exhibit PT-4.
5. Letter from Central Examination Section – RAL to Taxpayers dated December 13, 2001, a copy of which is designated as Exhibit PT-5.
6. Letter from Husband to Central Examination Section – RAL dated December 17, 2001, a copy of which is designated as Exhibit PT-6.
7. Undated letter from Husband to the Department of Revenue, a copy of which is designated as Exhibit PT-7.
8. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayers dated March 14, 2002, a copy of which is designated as Exhibit PT-8.
9. Letter from Husband to Patrick G. Penny dated March 18, 2002, a copy of which is designated as Exhibit PT-9.
10. Letter from Eugene J. Cella to Taxpayers dated May 31, 2002, a copy of which is designated as Exhibit PT-10.

FINDINGS OF FACT

Based on the foregoing evidence of record, the 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 individual income tax return for the tax year 2000.
3. Taxpayers' 2000 return reflected federal taxable income of zero, North Carolina income tax of zero, and North Carolina tax withheld of \$518.00. Taxpayers requested a refund of \$518.00.
4. Wage history information from the Employment Security Commission shows that Husband had wages of at least \$11,472.00.
5. Upon examination, the Department calculated Taxpayers' federal taxable income to be negative \$1,478.00, consisting of wages of \$11,472.00 based on the Employment Security Commission report; the standard deduction for a married couple filing jointly; and two personal exemptions.
6. North Carolina taxable income was determined to be \$1,472.00 by increasing the corrected federal taxable income by \$2,350.00 for the difference between the amount allowed for the federal standard deduction and the State standard deduction and by

\$600.00 for the difference between the amount allowed for the federal personal exemptions and the State personal exemptions.

7. A Notice of Individual Income Tax Assessment proposing an assessment of additional income tax, a frivolous return penalty, and accrued interest totaling \$593.22 was mailed to Taxpayers on December 13, 2001. Taxpayers objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
8. Subsequent to receiving the hearing request, the Department of Revenue determined that Taxpayers had not been given credit for North Carolina income tax withheld of \$518.00. The allowance of the income tax withheld reduces the balance due to \$70.00, which represents the remaining balance of the frivolous return penalty.
9. Taxpayers contend that (1) Taxpayers had no income during 2000; (2) compensation for labor is not income; (3) the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return; (4) the Department of Revenue does not have the authority to make changes to their return or to issue an assessment against them; (5) the income tax is voluntary; and (6) their return cannot be held as "frivolous" and a \$500 penalty be imposed on any basis.

CONCLUSIONS OF LAW

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

1. 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. 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.
2. 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.
3. 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 2000.
4. 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. 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. An income tax return shall be filed as prescribed by the Secretary. The return shall be in the form prescribed by the Secretary.

5. 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.
6. 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.
7. A penalty of up to \$500.00 can be imposed for filing a frivolous return. A frivolous return is a return that meets both of the following requirements: (a) it fails to provide sufficient information to permit a determination that the return is correct or contains information which positively indicates the return is incorrect, and (b) it evidences an intention to delay, impede, or negate the revenue laws of this State or purports to adopt a position that is lacking in seriousness. A penalty of \$500.00 was properly assessed for the tax year 2000 because the 2000 individual income tax return filed by Taxpayers satisfies both of these requirements.
8. 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.
9. The proposed assessment for the tax year 2000, modified to allow credit of \$518.00 for income tax withheld, is lawful and proper.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary finds the proposed assessment for the tax year 2000, to the extent hereinafter modified, to be lawful and proper and is hereby affirmed.

Taxpayers contend that they do not have an income tax liability for 2000 because they did not have any income during 2000. They base their contention on the argument that compensation for labor is not income and cite *Oliver v. Halstead*, 196 Va. 992, 86 S.E.2d 859, in support of their position. *Oliver v. Halstead*, a Virginia Supreme Court decision, was not a tax

decision, but a decision interpreting Virginia's nonprofit corporation law. Specifically, the issue before the court was whether compensation paid to an employee of the corporation was a private "profit" prohibited by the nonprofit corporation law. The court held that a payment of compensation for labor is not the same as a "profit" from the corporation. This is completely irrelevant to whether the payment is taxable income to the employee.

Taxpayers further contend that they do not have income because the Internal Revenue Code does not define "income" and the United States Supreme Court has defined "income" to include only corporate profits. As Taxpayers state by citing *U.S. v. Ballard*, 535 F.2d 400 (1976), the term "income" is not defined in the Internal Revenue Code ("Code"), nor is it defined in the North Carolina Revenue Laws. However, both federal and State law impose the individual income tax on the "taxable income" of every individual (Code section 1, G.S. 105-134). The State's definition of taxable income (G.S. 105-134.1(16)) refers to the definition of taxable income in Code section 63. Taxable income for federal purposes means gross income less allowable deductions. Gross income is defined by Code section 61 as, except as otherwise provided, all income from whatever source derived, including compensation for services. The decision in *Ballard* does not support Taxpayers' position that they have no North Carolina income tax liability. In *Ballard*, the court continued by reciting the Code's definition of "gross income," which includes compensation for services, including fees, commissions, and similar items. The case did not deal with the issue of whether wages are income. *Ballard* was concerned primarily with income from a merchandising business and whether gross income was the gross receipts from the business or gross receipts less expenses. The taxpayer had reported wages in gross income and did not argue that wages were not taxable. Therefore, the question is not whether there is such a thing as income but whether wages or other compensation received for services rendered are considered income. Pursuant to 26 CFR 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 includible in gross income.

Taxpayers contend that income is limited to corporate profit and cite such cases as *Eisner v. Macomber*, 252 U.S. 189, 40 S. Ct. 189 (1920), *Merchant's Loan and Trust Co. v. Smietanka*, 255 U.S. 509, 41 S. Ct. 386 (1921), *Doyle v. Mitchell Brothers Company*, 247 U.S. 179, 38 S. Ct. 467 (1918), *Stratton's Independence Limited v. Howbert*, 231 U.S. 399 (1913), and *Southern Pacific Company v. Lowe*, 247 U.S. 330, 38 S. Ct. 540 (1918), in support of their position. None of the cases support their argument. In *Eisner*, the court held that stock dividends are not income and hence are not taxable as such. The basis for the court's decision is that the shareholder received nothing as a result of the stock dividend for his separate use and benefit; on the contrary, every dollar of his investment remained the property of the company. The court defined income as "the gain derived from capital, from labor, or from both combined..." In *Commissioner of Internal Revenue v. Glenshaw Glass Co.*, 348 U.S. 426, 99 L.Ed. 483 (1955), the court concluded that *Eisner* was not meant to provide a touchstone to all future gross income questions. A taxpayer is taxable on "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." The statutory definition of gross income is "all-inclusive." In *Merchant's Loan and Trust Co.*, the court found that the word income must be given the same meaning in all of the income tax acts of Congress that was given to it in the Corporation Excise Tax Act of 1909. However, that does not imply that income can only be a derivative of corporate activity. In *Merchant's Loan and Trust Co.*, the plaintiff was a trust established at the death of the grantor. The trust sold stock and received sales proceeds in excess of the basis in the stock. The court held that a trust was a taxable person; therefore it is clear that income is not limited to corporate activities. The court also held that the gain from the sale of stock was income, stating that income may be defined as the gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital assets. *Doyle*, *Stratton's Independence*, and *Southern Pacific* are not relevant; in each case, the plaintiff was a corporation. Therefore, the question of whether wages received by an individual are income was not at issue in those cases. The courts have

consistently held that wages and other forms of compensation for services rendered are income.

Taxpayers contend that the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return. Taxpayers also assert that the income tax is voluntary. A hearing before the Secretary of Revenue with respect to a proposed assessment of North Carolina income tax is not the proper forum to determine if the Internal Revenue Code imposes an income tax or requires a return to be filed; those issues are between the Taxpayers and the Internal Revenue Service. However, I note that section 1 of the Internal Revenue Code imposes an income tax on individuals and Code section 6012(a)(1)(A) requires an individual to file a federal income tax return if his gross income for the year equals or exceeds the allowable exemption amount. More importantly, since a North Carolina income tax liability is at issue, I find that State law clearly and unequivocally imposes a State income tax on Taxpayers and requires them to file a State income tax return. The income tax is clearly not voluntary. While both the Internal Revenue Service and the Department of Revenue rely heavily on voluntary compliance by taxpayers, the filing of an income tax return and the payment of income tax are mandatory. Otherwise, the law would not impose penalties, both civil and criminal, for failure to do so.

Taxpayers argue that the Department of Revenue has no authority to make changes to their return or to issue an assessment against them. The Department of Revenue has the authority to determine an individual's correct federal taxable income for purposes of determining the individual's North Carolina income tax liability. G.S. 105-134.5 defines North Carolina taxable income as the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted as provided in G.S. 105-134.6 and G.S. 105-134.7. "Taxable income as determined under the Code" does not mean the taxable income taxpayer chooses to report on his or her return, but rather the taxable income as it should actually be calculated under the Code. Therefore, if an individual calculates federal taxable income incorrectly or reports no

taxable income on his federal return, the State is not bound by the amount reported. G.S. 105-258 authorizes the Department of Revenue to examine materials for the purpose of ascertaining the correctness of any return or determining a person's liability for State tax. Therefore, the Department of Revenue has the authority to use information other than that provided on a taxpayer's federal return to determine what taxes are actually owed to the State. The Secretary of Revenue, as the head of the Department of Revenue, cannot individually propose all tax assessments and that is certainly not the intent of the law. Assessments of tax must be "of the Secretary," meaning that the assessments may only be proposed by the Department of Revenue. The law also does not require the Secretary to issue a delegation of authority in writing to each of the Department's employees to perform the duties of their job. G.S. 105-258 empowers the Secretary to appoint agents to determine liabilities of all persons for any tax imposed under the Revenue Act. The authority of an employee of the Department of Revenue to perform the duties of his or her position is implicit and arises automatically from the individual's appointment by the Secretary to that position.

Finally, Taxpayers contend that their return cannot be held as "frivolous" and a \$500 penalty be imposed on any basis. Where there is no state case law interpreting a statute, it is appropriate to look to Federal court decisions for interpretations and enlightenment. The courts have repeatedly upheld the imposition of frivolous return penalties under Section 6702 of the Internal Revenue Code. In *Thompson v. Internal Revenue Service*, 86-1 USTC (CCH) ¶ 9420, the Court found that frivolous tax return penalties were properly imposed against individuals who file returns listing their wages, salaries, and tips to be zero even though they received substantial wage income as reflected on their wage and tax statements. In *Thompson*, the Court ruled that "the returns contained information on their face which indicated that the self-assessments were substantially incorrect." The Court further noted that the plaintiffs' position that wages are not income is "a position which the courts have repeatedly rejected as frivolous." In *Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68 (7th Cir. 1986), the Court

established that “a petition to the Tax Court, or a tax return, is frivolous if it is contrary to established law and unsupported by a reasoned, colorable argument for change in the law.” The Court further held that the purpose of Code Section 6702 “is to compel taxpayers to think and to conform their conduct to settled principles before they file returns.” I find that G.S. 105-236(10a) has the same purpose. Because Taxpayers entered zero on most lines of their return, sufficient information was not available on the return to determine its correctness. Such action by Taxpayers, coupled with their trite arguments, positively concludes that their return promotes a position that is lacking in seriousness and adopted for the purpose of negating the State revenue laws. Thus, the penalty asserted against Taxpayers for filing a frivolous return is appropriate within the meaning of the law.

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 individuals 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. Therefore, the proposed assessment for the tax year 2000, modified to allow credit for North Carolina income tax withheld of \$518.00, is hereby sustained in its entirety and is determined to be finally due and collectible.

Made and entered this 29th day of August, 2002.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue