

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 1998)
and 1999 by the Secretary of Revenue)
of North Carolina)
)
vs.)
)
[Taxpayer])

FINAL DECISION
Docket No. 2002-705

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on February 13, 2003, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessments of additional income tax for the taxable years 1998 and 1999. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer; W. Edward Finch, Jr., Assistant Director of the Personal Taxes Division; Patrick G. Penny, Administrative Officer in the Personal Taxes Division; and, with Taxpayer's permission and at his request, [Taxpayer's wife].

Pursuant to G.S. 105-241.1, assessments proposing additional tax, penalties, and interest for the tax years 1998 and 1999 were mailed to Taxpayer on May 21, 2002. Taxpayer filed a timely protest to the proposed assessments and requested a hearing before the Secretary of Revenue.

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 1998 and 1999 lawful and proper?

EVIDENCE

The evidence presented by W. Edward Finch, Jr., Assistant 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 for Administrative Tax 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 1998 dated May 21, 2002, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1999 dated May 21, 2002, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1998 dated October 15, 2002, a copy of which is designated as Exhibit PT-4.
5. Internal Revenue Service Report of Income Tax Examination Changes dated February 20, 2001, a copy of which is designated as Exhibit PT-5.
6. Letter from Taxpayer to the Department of Revenue dated June 18, 2002, a copy of which is designated as Exhibit PT-6.
7. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayer dated September 30, 2002, a copy of which is designated as Exhibit PT-7.
8. Letter with enclosure entitled Taxable Income from Taxpayer to Patrick G. Penny dated October 29, 2002, copies of which are designated as Exhibit PT-8.
9. Letter from Eugene J. Cella to Taxpayer dated November 21, 2002, a copy of which is designated as Exhibit PT-9.
10. Letter from Taxpayer to Eugene J. Cella dated December 7, 2002, a copy of which is designated as Exhibit PT-10.
11. Letter from Taxpayer to E. Norris Tolson dated December 24, 2002, a copy of which is designated as Exhibit PT-11.
12. Letter from Patrick G. Penny to Taxpayer dated January 7, 2003, a copy of which is designated as Exhibit PT-12.
13. Letter from Eugene J. Cella to Taxpayer dated January 7, 2003, a copy of which is designated as Exhibit PT-13.

Taxpayer presented the following evidence at the hearing:

1. Document entitled Liability, a copy of which is designated as Exhibit TP-1.
2. Document entitled Right to Labor, a copy of which is designated as Exhibit TP-2.

At the conclusion of the hearing, the Assistant Secretary allowed Taxpayer until March 15, 2003, to submit additional information for the record in support of his objection to the proposed assessments. The Assistant Secretary received a letter from Taxpayer, a copy of which is designated as Exhibit TP-3. The compact disks referred to in Exhibit TP-3 are on file in the Assistant Secretary's office.

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 1998 and 1999.
3. The Department of Revenue received reports from the Internal Revenue Service indicating that the Internal Revenue Service had determined Taxpayer's federal taxable income to be \$21,474.00 for the tax year 1998 and \$130,401.00 for the tax year 1999. The filing status of married filing separately was used in the federal determination.
4. Upon examination, the Department determined Taxpayer's North Carolina taxable income for tax year 1998 to be \$20,950.00 by adding \$200.00 (representing the amount the federal personal exemption had increased for inflation reduced by \$500.00) to the corrected federal taxable income from the federal report and deducting \$724.00 (representing the amount of state income tax refund that was included in Taxpayer's federal taxable income). The Department determined Taxpayer's North Carolina taxable income for tax year 1999 to be \$131,151.00 by adding \$750.00 (representing the amount the federal personal exemption had increased for inflation) to the corrected federal taxable income from the federal report.
5. Pursuant to G.S. 105-241.1, Notices of Individual Income Tax Assessment reflecting additional tax, penalties, and interest of \$2,512.87 and \$17,161.31 for the tax years 1998 and 1999, respectively, were mailed to Taxpayer on May 21, 2002. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
6. Subsequent to receiving the hearing request, the Department of Revenue determined that the personal exemption adjustments of \$200.00 and \$750.00 for the tax years 1998 and 1999, respectively, were added to the corrected federal taxable income amounts in error. Since Taxpayer was not allowed a personal exemption in the Internal Revenue Service's determinations of his 1998 and 1999 federal taxable income, no personal exemption adjustments are required. As a result, North Carolina taxable income for the tax years 1998 and 1999 should be reduced by \$200.00 and \$750.00, respectively.
7. Subsequent to receiving the hearing request, the Department of Revenue determined Taxpayer was entitled to a deduction from federal taxable income of \$2,000.00 for private retirement benefits for the tax year 1998 since Taxpayer's corrected 1998 federal taxable income included a distribution of \$3,006.00 from Taxpayer's Individual Retirement Arrangement (IRA). As a result, North Carolina taxable income for the tax year 1998 should be reduced by \$2,000.00.
8. Taxpayer contends that (1) he does not receive or earn income since the Internal Revenue Code does not define "income;" (2) income is limited to corporate profit; (3) the sources of income identified in Federal Regulation 1.861-8(f)(1) are the only sources that can produce gross income; (4) the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return; (5) income tax is voluntary and taxpayers are the only ones who can "self-assess" the tax;

and (6) the State has delegated its power of taxation to the United States Congress in violation of the North Carolina Constitution.

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. 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.
4. If an individual receives retirement benefits from an IRA, a deduction from federal taxable income is allowed for the amount of those retirement benefits included in federal taxable income or \$2,000.00, whichever is less.
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 the later. When a return has not been filed, there is no statute of limitations and an assessment can be proposed at any time.
7. 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). Because Taxpayer did not file the returns, penalties of \$302.00 and \$2,406.25 (as recalculated) for failure to file the returns when due were properly assessed for the years 1998 and 1999, respectively.

8. A penalty is imposed for failure to pay tax when due. The penalty is equal to ten percent of the tax (minimum \$5.00). Because Taxpayer did not pay the tax when due, penalties of \$120.80 and \$962.50 (as recalculated) were properly assessed for the years 1998 and 1999, respectively.
9. 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 \$302.00 and \$2,406.25 (as recalculated) were properly assessed for the years 1998 and 1999, respectively because Taxpayer understated taxable income by 25 percent or more of gross income.
10. A penalty is imposed for underpayment of estimated income tax if the taxpayer does not pay estimated income tax of at least ninety percent of the tax shown on the current year's return, or if no return is filed, ninety percent of the tax for that year or one hundred percent of the tax shown due on the previous year's return, whichever is less. The penalty is not due if the tax due on the return, reduced by the North Carolina tax withheld and allowable tax credits, is less than \$1,000.00. A penalty of \$64.51 (as recalculated) for underpayment of estimated income tax was properly assessed for the year 1999.
11. 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.
12. The proposed assessments for the tax years 1998 and 1999, modified to exclude the personal exemption adjustments and to include a \$2,000.00 retirement benefits deduction for the tax year 1998, are lawful and proper.

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 1998 and 1999, to the extent hereinafter modified, to be lawful and proper and are hereby affirmed.

Taxpayer contends that he does not have income because the Internal Revenue Code ("Code") does not define "income" and the United States Supreme Court has defined "income" to include only corporate profits. As Taxpayer states by citing *U.S. v. Ballard*, 535 F.2d 400 (1976), the term "income" is not defined in the Code, nor is it defined in the North Carolina

Revenue Laws. Black's Law Dictionary defines income as money or other form of payment one receives from employment, business, investments, and the like. 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 Taxpayer's position that he has 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.

Taxpayer contends that income is limited to corporate profit and cites such cases as *Eisner v. Macomber*, 252 U.S. 189 (1920), *Merchant's Loan and Trust Co. v. Smietanka*, 255 U.S. 509 (1921), *Doyle v. Mitchell Brothers*, 247 U.S. 179 (1918), *Stratton's Independence v. Howbert*, 231 U. S. 399 (1913), and *Southern Pacific v. Lowe*, 247 U.S. 330 (1918), in support of his position. None of the cases support his 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 U.S. Supreme 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 infer that income can only be a derivative of corporate activity. In *Merchant’s*, 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 or other forms of compensation 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.

Taxpayer contends that the sources of income listed in 26 CFR 1.861-8(f)(1) are the only sources that can produce gross income. Taxpayer contends he had no taxable income during the years in question since he had no income from the sources listed in 26 CFR 1.861-8(f)(1). Taxpayer further contends he was not required to file federal returns for the years in question since he had no taxable income for those years. Section 861 of the Code and its regulations are for the purpose of determining whether income of United States citizens, resident aliens, foreign taxpayers, and nonresident aliens is derived from United States or foreign sources. For

federal tax purposes, United States citizens, resident aliens, and domestic corporations are generally taxed on all of their income; however, the source of the income is important for determining foreign tax credits, foreign income exclusions, etc. Section 861 is not relevant in Taxpayer's case since it is not necessary for Taxpayer to determine whether his income is from sources within or outside the United States unless Taxpayer is eligible for a foreign tax credit, which is not the case. Gross income for income tax purposes is determined pursuant to Section 61 of the Code, not Section 861 or its regulations as Taxpayer contends. 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." Therefore, for taxable years 1998 and 1999, Taxpayer had gross income as defined in Section 61 of the Code as well as taxable income as defined in Section 63 of the Code.

Taxpayer contends that no section of the Internal Revenue Code imposes an income tax liability or provides that income taxes have to be paid on the basis of a return. 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 liability or requires a return to be filed; those issues are between Taxpayer 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, G.S. 105-134 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. A resident of this State is required under G.S. 105-152 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 law clearly and unequivocally imposes a State income tax on Taxpayer and requires him to file a State income tax return.

Taxpayer contends that the income tax is voluntary and that taxpayers are the only ones who can “self-assess” the tax. Such is clearly not the case. 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. The Department of Revenue has the statutory authority and responsibility to ensure that the residents of North Carolina report and pay their correct income tax liabilities. G.S. 105-258 provides that 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. If a taxpayer does not provide adequate and reliable information upon which to compute the tax liability, G.S. 105-241.1 provides that an assessment may be made upon the basis of the best information available.

Taxpayer contends that the State is in violation of the North Carolina Constitution because a taxpayer’s North Carolina taxable income means the taxpayer’s taxable income as determined under the Internal Revenue Code. Section 2(1) of Article V of the Constitution provides in pertinent part that the “power of taxation...shall never be surrendered, suspended, or contracted away.” To adopt by reference future amendments to the Code would likely be held to be an unconstitutional delegation of legislative power. Taxpayer’s argument fails, however, because the State’s reference to the Code does not automatically adopt future

changes to the Code. G.S. 105-228.90 defines "Code" by referring to the Code as of a specific date. The definition is revised as needed to reflect the General Assembly's decision to adopt amendments to the Code. The General Assembly always uses a reference date equal to or prior to the date the legislation is enacted to insure that it is not delegating its power to tax to the United States Congress.

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 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 assessments for the tax year 1998 and 1999, modified to exclude the personal exemption adjustments and to include a \$2,000.00 retirement benefits deduction for the tax year 1998, are hereby sustained in their entireties and are determined to be finally due and collectible.

Made and entered this 7th day of May, 2003.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue