

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)
through 2000 by the Secretary of Revenue)
of North Carolina)
)
vs.)
)
[Taxpayer])

FINAL DECISION
Docket No. 2003-413

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for hearing by [Taxpayer] wherein he protested the proposed assessments of additional income tax for the taxable years 1998, 1999, and 2000. At Taxpayer's request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayer until November 21, 2003, to provide any arguments, documents, or other evidence in support of his objections to the assessments. The hearing was conducted by the Assistant Secretary under the provisions of G.S. 105-260.1.

Pursuant to G.S. 105-241.1, assessments proposing additional tax, penalties, and interest for the tax years 1998, 1999, and 2000 were mailed to Taxpayer on August 5, 2003. Taxpayer objected to the proposed assessments and requested an administrative tax 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, 1999, and 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 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 August 5, 2003, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1999 dated August 5, 2003, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 2000 dated August 5, 2003, a copy of which is designated as Exhibit PT-4.
5. Internal Revenue Service Report of Income Tax Examination Changes dated November 7, 2001, a copy of which is designated as Exhibit PT-5.
6. Letter from G. D. Drum, Revenue Tax Auditor, to Taxpayer dated February 14, 2003, a copy of which is designated as Exhibit PT-6.
7. Letter from Taxpayer to G. D. Drum dated February 18, 2003, a copy of which is designated as Exhibit PT-7.
8. Letter from G. D. Drum to Taxpayer dated February 27, 2003, a copy of which is designated as Exhibit PT-8.
9. Letter from Taxpayer to the Department of Revenue dated August 11, 2003, a copy of which is designated as Exhibit PT-9.
10. Letter from Taxpayer to the Department of Revenue dated August 12, 2003, a copy of which is designated as Exhibit PT-10.
11. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayer dated September 24, 2003, a copy of which is designated as Exhibit PT-11.
12. Letter from Eugene J. Cella to Taxpayer dated September 24, 2003, a copy of which is designated as Exhibit PT-12.
13. Letter from Taxpayer to Eugene J. Cella dated September 30, 2003, a copy of which is designated as Exhibit PT-13.
14. Letter from Eugene J. Cella to Taxpayer dated October 6, 2003, a copy of which is designated as Exhibit PT-14.
15. Letter from Eugene J. Cella to Taxpayer dated October 21, 2003, a copy of which is designated as Exhibit PT-15.

Taxpayer submitted a letter dated October 30, 2003, with four related exhibits, copies of which are collectively designated as Exhibit TP-1.

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, 1999, and 2000.
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 \$101,787.00 for the tax year 1998; \$26,766.00 for the tax year 1999; and \$17,449.00 for the tax year 2000. The federal taxable income amounts were determined by allowing the standard deduction for the filing status of married filing separately and one personal exemption.
4. Upon examination, the Department determined Taxpayer's North Carolina taxable income for tax year 1998 to be \$103,369.00 by adding \$1,582.00 (representing the amount the federal standard deduction for married filing separately and the federal personal exemption had increased for inflation) to the corrected federal taxable income from the federal report. The Department determined Taxpayer's North Carolina taxable income for tax year 1999 to be \$28,116.00 by adding \$1,350.00 (representing the amount the federal standard deduction for married filing separately and the federal personal exemption had increased for inflation reduced by \$500.00) to the corrected federal taxable income from the federal report. The Department determined Taxpayer's North Carolina taxable income for tax year 2000 to be \$18,924.00 by adding \$1,475.00 (representing the amount the federal standard deduction for married filing separately and the federal personal exemption had increased for inflation reduced by \$500.00) 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 \$14,424.82, \$3,509.05, and \$2,198.58 for the tax years 1998, 1999, and 2000, respectively, were mailed to Taxpayer on August 5, 2003. 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 Taxpayer was entitled to a deduction from federal taxable income of \$2,000.00 for private retirement benefits for the tax years 1998 and 2000. North Carolina taxable income for each of the tax years 1998 and 2000 should be reduced by \$2,000.00.
7. Taxpayer contends that (1) he had no taxable income during the years at issue; (2) the sources of income identified in Federal Regulation 1.861-8(f)(1) are the only sources that can produce gross income; (3) the income tax applies only to government employees and people exercising "privileges" or engaged in "revenue taxable activities;" and (4) he owes no North Carolina income tax because all of his remuneration is received in the form of Federal Reserve Notes, which are exempt from State taxation.

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 every resident of 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 must show the taxable income and adjustments to federal taxable income required by statute.
4. Additions to federal taxable income are required for the amount by which a taxpayer's standard deduction has been increased for inflation under Code section 63(c)(4)(A) and the amount by which each of a taxpayer's personal exemptions has been increased for inflation under Code section 151(d)(4)(A). The appropriate additions were made for each tax year at issue.
5. 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. Taxpayer is entitled to this deduction for the taxable years 1998 and 2000.
6. 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.
7. 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.
8. 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 \$1,843.75 (as recalculated), \$465.75, and \$269.75 (as recalculated) for failure to file the returns when due were properly assessed for the years 1998, 1999 and 2000, respectively.
9. 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 \$737.50 (as recalculated), \$186.30, and \$107.90 (as recalculated) were properly assessed for the years 1998, 1999 and 2000, respectively.

10. 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. Because Taxpayer understated taxable income by 25 percent or more of gross income, penalties of \$1,843.75 (as recalculated), \$465.75, and \$269.75 (as recalculated) were properly assessed for the years 1998, 1999, and 2000, respectively.
11. 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. Penalties of \$89.55 and \$51.86 (as recalculated) for underpayment of estimated income tax were properly assessed for the years 1999 and 2000, respectively.
12. 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.
13. The proposed assessments for the tax years 1998, 1999, and 2000, modified to include a \$2,000.00 retirement benefits deduction for the tax years 1998 and 2000, 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, 1999, and 2000, to the extent hereinafter modified, to be lawful and proper and are hereby affirmed.

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 at issue 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, 1999, and 2000 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 the income tax applies only to government employees and people exercising "privileges" or engaged in "revenue taxable activities." The courts have consistently rejected this argument as frivolous. In *Sullivan v. United States*, 788F.2d 813, 815 (1st Cir.1986), the court concluded that "to the extent Sullivan argues that he received no 'wages' in 1983 because he was not an 'employee' within the meaning of 26 U.S.C. § 3401 (c), that contention is meritless. Section 3401 (c), which relates to income tax withholding, indicates that the definition of 'employee' includes government officers and employees, elected officials, and corporate officers. The statute does not purport to limit withholding to the persons listed therein." In *Pabon v. Commissioner*, T. C. Memo 1994-476, the petitioner alleged, among other things, that he "is not an employee of the Federal or state governments, is not engaged in a revenue taxable activity of alcohol, tobacco, or firearms, and therefore not subject to any excise tax..." The court concluded that the petition "is nothing but tax protestor rhetoric and legalistic gibberish..." In *United States v. Sloan*, 939 F.2d499, 501(7th Cir. 1991), cert. Den. 112 S Ct.

940(1992), the court held that “All individuals, freeborn and nonfreeborn, natural and unnatural alike, must pay federal income tax on their wages, regardless of whether they have requested, obtained, or exercised any privilege from the federal government.”

Taxpayer contends that he owes no North Carolina income tax because all of his remuneration is received in the form of Federal Reserve Notes, which are exempt from State taxation. Taxpayer argues that Federal Reserve Notes are defined as obligations of the United States under 12 USC § 411 and, therefore, are exempt from taxation by North Carolina under the provisions of 31 USC § 3124 (formerly 31 USC § 742). Taxpayer’s contention is incorrect. The definition of Federal Reserve Notes as “obligations of the United States” within the context of 12 USC § 411 is clearly distinguishable from the meaning used in 31 USC § 3124. Section 411 is contained within Title 12 of the United States Code which created the Federal Reserve System, and in which Federal Reserve Notes are defined as “obligations of the United States.” The intent is to make clear that the notes are authorized currency of the United States. The term “obligations of the United States” as used in 31 USC § 3124 refers to interest bearing instruments such as United States bonds. Each of the cases Taxpayer has cited in support of his argument deal with either property taxes or state bank taxes imposed on banks with respect to United States bonds and other securities. While the courts in those cases held that obligations of the United States government were exempt from taxation by State or local governments, in none of the cases did a State or local government attempt to tax Federal Reserve Notes. In *Richey v. Indiana Department of State Revenue* 634 NE 2d. 1375 (1994), the court also found that federal obligations are exempt from state taxation; however, the court also stated “federal reserve notes are not federal obligations within the meaning of the exemption. Instead, like other types of U.S. currency and coins, they are ‘legal tender’ for all debts, public charges, taxes, and dues.” The Federal Reserve Notes Taxpayer receives as remuneration are not “obligations of the United States” which are exempted from North Carolina

income tax. The North Carolina income tax is levied on Taxpayer's taxable income, which may or may not be received in the form of Federal Reserve Notes.

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 years 1998, 1999, and 2000, modified to include a \$2,000.00 retirement benefits deduction for the tax years 1998 and 2000, are hereby sustained in their entireties and are determined to be finally due and collectible.

Made and entered this 17th day of February, 2004.

Signature_____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue