

**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. )  
[Taxpayers] )

**FINAL DECISION**  
Docket No. 2003-554

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for hearing by [taxpayers] wherein they protested the proposed assessments of additional income tax for the taxable years 1998, 1999, and 2000. [Taxpayer's Husband] hereinafter referred to separately as "Husband." At Husband's request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayers until April 30, 2004, to provide any arguments, documents, or other evidence in support of their 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, an assessment proposing additional tax, penalties, and interest for the tax year 1998 was mailed to Taxpayers on September 24, 2002. Assessments proposing additional tax, penalties, and interest for the tax years 1999 and 2000 were mailed to Taxpayers on October 14, 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 Taxpayers 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. Taxpayers' North Carolina individual income tax return for the taxable year 1998, a copy of which is designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for the taxable year 1999, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 2000, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1998 dated September 24, 2002, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 1999 dated October 14, 2003, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for the taxable year 2000 dated October 14, 2003, a copy of which is designated as Exhibit PT-7.
8. Internal Revenue Service Report of Income Tax Changes for tax year 1998, a copy of which is designated as Exhibit PT-8.
9. Internal Revenue Service Report of Income Tax Changes for tax years 1999 and 2000, a copy of which is designated as Exhibit PT-9.
10. Letter from J. C. Davenport, Revenue Tax Auditor, to Taxpayers' S corporation dated July 11, 2003, a copy of which is designated as Exhibit PT-10.
11. Letter from Husband to J. C. Davenport with related attachments, copies of which are collectively designated as Exhibit PT-11.
12. Letter from J. C. Davenport to Taxpayers dated October 14, 2003, a copy of which is designated as Exhibit PT-12.
13. Letter from Taxpayers to Secretary of Revenue dated November 7, 2003, a copy of which is designated as Exhibit PT-13.
14. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayers dated December 16, 2003, a copy of which is designated as Exhibit PT-14.
15. Letter from Eugene J. Cella to Taxpayers dated December 15, 2003, a copy of which is designated as Exhibit PT-15.

16. Facsimile letter from Husband to Department of Revenue dated February 9, 2004, a copy of which is designated as Exhibit PT-16.
17. Letter from Eugene J. Cella to Taxpayers dated February 10, 2004, a copy of which is designated as Exhibit PT-17.

Husband submitted a Determination Letter with accompanying documents to Eugene J. Cella dated April 26, 2004, copies of which are collectively designated as Exhibit TP-1.

### **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 returns for the tax years 1998 and 1999. Taxpayers filed their 2000 individual income tax return late on May 31, 2001. The 1998 return reflected federal taxable income of \$(29,405.00) and North Carolina taxable income of \$(28,932.00). The 1999 return reflected federal taxable income of \$(14,919.00) and North Carolina taxable income of \$(13,013.00). The 2000 return reflected federal taxable income of \$(26,021.00) and North Carolina taxable income of \$(25,408.00). Taxpayers subsequently amended their 1998 return to increase their federal taxable income and North Carolina taxable income by \$390.00 to \$(29,015.00) and \$(28,542.00), respectively.
3. The Department of Revenue received reports from the Internal Revenue Service indicating that the Internal Revenue Service had audited Taxpayers' 1998, 1999, and 2000 federal income tax returns. The Internal Revenue Service determined Taxpayers' correct federal taxable income to be \$78,903.00, \$188,671.00, and \$207,114.00 for the tax years 1998, 1999 and 2000, respectively.
4. Upon examination, the Department increased Taxpayers' North Carolina taxable income by \$107,918.00, \$203,590.00, and \$233,135.00 for the tax years 1998, 1999, and 2000, respectively, for the increases in federal taxable income reflected on the federal reports. After these increases, Taxpayers' corrected North Carolina taxable income for the tax years 1998, 1999, and 2000 is \$79,376.00, \$190,577.00, and \$207,727.00, respectively.
5. Pursuant to G.S. 105-241.1, a Notice of Individual Income Tax Assessment reflecting additional tax, penalties, and interest of \$8,099.80 for the tax year 1998 was mailed to Taxpayers on September 24, 2002. Notices of Individual Income Tax Assessment reflecting additional tax, penalties, and interest of \$20,642.36 and \$22,932.85 for the tax years 1999 and 2000, respectively, were mailed to Taxpayers on October 14, 2003. Taxpayers objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
6. Subsequent to receiving Taxpayers' hearing request, the Department discovered an error in the computation of Taxpayers' 1998 North Carolina taxable income. Because Taxpayers'

corrected adjusted gross income for tax year 1998 exceeds \$100,000.00, Taxpayers' 1998 personal exemption adjustment must be increased to \$1,400.00. Therefore, the Department has recalculated Taxpayers' North Carolina taxable income to be \$80,376.00 for the tax year 1998. Penalties and interest have also been recalculated based on the corrected tax.

7. Subsequent to receiving Taxpayers' hearing request, the Department identified errors in the computation of Taxpayers' 1999 and 2000 North Carolina taxable incomes. Due to the large increase in Taxpayers' adjusted gross incomes for the tax years 1999 and 2000, Taxpayers' itemized deductions and personal exemptions were limited for federal income tax purposes. Therefore, Taxpayers' adjustment for state and local income tax for the tax years 1999 and 2000 must be decreased to \$1,191.00 and \$1,188.00, respectively, and Taxpayers' personal exemption adjustments for the tax years 1999 and 2000 must be increased to \$1,290.00 and \$1,184.00, respectively. After correcting these errors, the Department recalculated Taxpayers' North Carolina taxable incomes to be \$191,152.00 and \$208,080.00 for the tax years 1999 and 2000, respectively.
8. Taxpayers contend that they do not have any statutory income and that they are not required to keep books and records for their businesses. Taxpayers also raise numerous constitutional arguments against the imposition of the individual income tax.

### **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 addition to federal taxable income is required for the amount deducted from gross income under section 164 of the Code as state, local, or foreign income tax to the extent that the taxpayer's total itemized deductions deducted under the Code for the taxable year exceed the allowable State standard deduction.
4. An addition to federal taxable income is required for the amount by which each of the taxpayer's personal exemptions has been increased for inflation under section 151(d)(4)(A) of the Code. For taxpayers with the filing status of married filing jointly, this amount is reduced by \$500 for each personal exemption if the taxpayers' adjusted gross income, as calculated under the Code, is less than \$100,000. If the taxpayer's personal exemptions have been reduced by the applicable percentage under section 151(d)(3) of the Code, the amount by which the personal exemptions have been increased for inflation is also reduced by the applicable percentage.

5. Section 6103(d) of the Internal Revenue Code provides that federal income tax returns and return information are open to inspection by, or disclosure to, any State agency, body, or commission which is charged under the laws of that State with responsibility for the administration of the State's tax laws. Such inspection or disclosure is permitted only upon written request by the head of the agency or by an individual designated by the head of the agency. In 1982, the Department of Revenue and the Internal Revenue Service executed an Agreement on Coordination of Tax Administration that allows for the continuous sharing of tax information between the two agencies. The courts have consistently held that such standing agreement satisfies the written request requirement of Code section 6103(d).
6. If a taxpayer's federal taxable income is corrected or otherwise determined by the Internal Revenue Service, the taxpayer is required to file an income tax return with the State reflecting the corrected or determined taxable income within two years after being notified of the correction or final determination by the Internal Revenue Service. When the taxpayer does not file the required amended return and the Department obtains a copy of the Internal Revenue Service report, an assessment may be proposed for any additional tax, penalties, and interest at any time within three years from the date the report is received from the Internal Revenue Service.
7. If a taxpayer does not provide adequate and reliable information upon which the Department can accurately 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.
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 Taxpayers filed their 2000 return two months late, a ten percent penalty of \$1,516.40 (as recalculated) for failure to file the return when due was properly assessed for tax year 2000.
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. Because Taxpayers understated taxable income by 25 percent or more of gross income, penalties of \$1,353.50 (as recalculated), \$3,463.00 (as recalculated), and \$3,791.00 (as recalculated) were properly assessed for tax years 1998, 1999, and 2000, respectively.
10. 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.
11. The proposed assessments for the tax years 1998, 1999, and 2000, modified to include the corrections to the state income tax adjustments for tax years 1999 and 2000 and the corrections to the personal exemption adjustments for all three years, 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.

Husband 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. Many of the arguments are constitutional in nature. 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.

Husband attempts to discredit the proposed assessments through his interpretation of the Internal Revenue Service's individual master file of Taxpayers. This tactic is a total red herring, designed to avert attention away from the core issue. The Internal Revenue Service audited Taxpayers and made changes to Taxpayers' federal returns as reflected in the federal reports received by the Department from the Internal Revenue Service. Taxpayers have presented no factual evidence to show that the Internal Revenue Service's examination changes are not warranted.

Husband contends that Taxpayers do not have an income tax liability because they do not have statutory income. It is true that the term "income" is not defined in the Internal Revenue 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 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. 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. It is clear from the evidence that Taxpayers had gross income that far exceeded the minimum requirements for filing federal and State income tax returns.

Husband also contends that Taxpayers are not required to keep books and records for their businesses since they have never received a notice from the District Director of the Internal Revenue Service ordering them to keep such books and records. Taxpayers cite Treasury Delegation Order No. 24 in support of their position. It is obvious that Taxpayers have misinterpreted the purpose of this Treasury Delegation Order, which was to empower the Assistant Commissioner and the District Directors with the authority to require, by notice, any person to keep adequate records as to show whether or not such person is liable for tax under the Internal Revenue Code. In no way does this Treasury Delegation Order insinuate that a taxpayer is allowed to claim amounts of income and expense on a return without being able to provide documentation to support the amounts claimed. In most cases, the IRS does not require taxpayers to keep records in any special manner. For certain deductions and expenses, Treasury Regulations require specific records and documentation to be kept. Generally speaking, however, taxpayers should keep any and all documents that may have an impact on their tax return. Such items would include bills, receipts, invoices, mileage logs, canceled checks, or any other proof of payment, and any other records to support any deductions or credits they claim on their return. The responsibility to prove entries, deductions, and statements made on a tax return is known as the burden of proof. A taxpayer must be able to

substantiate certain elements of expenses to deduct them. Generally, taxpayers meet their burden of proof by having the information and receipts (where needed) for the expenses. Based on the reports received from the Internal Revenue Service, Taxpayers failed to meet their burden of proof.

The Assistant Secretary finds no merit in any of Taxpayers' arguments and defenses. Therefore, the proposed assessments for the tax years 1998, 1999, and 2000, modified to include the corrections to the state income tax adjustments for tax years 1999 and 2000 and the corrections to the personal exemption adjustments for all three years, are hereby sustained in their entireties and are determined to be finally due and collectible.

Made and entered this 12<sup>th</sup> day of July, 2004.

Signature\_\_\_\_\_

Eugene J. Cella  
Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue