

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 2002 by )  
the Secretary of Revenue of North Carolina )  
vs. )  
Taxpayer )

**FINAL DECISION**  
Docket No. 2004-231

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for hearing by Taxpayer, hereinafter referred to as "Taxpayer," wherein he protested the proposed assessment of additional income tax for the taxable year 2002. At Taxpayer's request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayer until June 21, 2004, to provide any arguments, documents, or other evidence in support of his objections to the assessment. 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 2002 was mailed to Taxpayer on March 16, 2004. Taxpayer filed a timely protest to the proposed assessment and requested an administrative tax 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 Taxpayer for the taxable year 2002 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. Taxpayer's North Carolina individual income tax return for the taxable year 2002 with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 2002 dated March 16, 2004, a copy of which is designated as Exhibit PT-3.
4. Taxpayer's wage and tax information obtained from a North Carolina business, a copy of which is designated as Exhibit PT-4.
5. Letter from Taxpayer to the Department of Revenue dated April 13, 2004, a copy of which is designated as Exhibit PT-5.
6. Letter from Eugene J. Cella to Taxpayer dated April 23, 2004, a copy of which is designated as Exhibit PT-6.
7. Letter from Taxpayer to Eugene J. Cella dated May 17, 2004, a copy of which is designated as Exhibit PT-7.
8. Letter from Eugene J. Cella to Taxpayer dated May 21, 2004, a copy of which is designated as Exhibit PT-8.

Taxpayer submitted a letter to Eugene J. Cella dated June 11, 2004, along with Taxpayer's brief, 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 timely filed his North Carolina income tax return for the tax year 2002.

3. Taxpayer's 2002 return reflected federal taxable income of *zero*, North Carolina income tax of *zero*, and North Carolina income tax withheld of \$2,157.25. Taxpayer requested a refund of \$2,157.25.
4. Wage and tax information obtained from a North Carolina business, shows that Taxpayer had wages of \$39,777.01 and North Carolina income tax withheld of \$2,157.25 in 2002.
5. Upon examination, the Department calculated Taxpayer's federal taxable income for the tax year 2002 to be \$32,077.00, consisting of wages of \$39,777.00; the standard deduction for the filing status of single; and one personal exemption.
6. The Department determined Taxpayer's North Carolina taxable income for the tax year 2002 to be \$34,277.00 by increasing Taxpayer's corrected federal taxable income by \$2,200.00 for the difference between the amounts allowed for the federal standard deduction and personal exemption and the State standard deduction and personal exemption.
7. Taxpayer was allowed credit of \$2,157.00 for the income tax withheld from his wages during the year.
8. A Notice of Individual Income Tax Assessment reflecting additional tax, penalties, and interest due of \$661.24 for the tax year 2002 was mailed to Taxpayer on March 16, 2004. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
9. Taxpayer contends that (1) he had no income during tax year 2002; (2) the income tax is voluntary and taxpayers are the only ones who can "self-assess" the tax; and (3) the Department of Revenue does not have the authority to change Taxpayer's return.

### **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. 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 \$2,200.00 were properly made for the tax year 2002.
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 must show the taxable income and adjustments to federal taxable income required by statute. An income tax return must be filed as prescribed by the Secretary and 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 may 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 2002 because the 2002 individual income tax return filed by Taxpayer satisfies both of these requirements.
8. 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, a penalty of \$28.75 has been properly imposed.
9. 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.

10. The proposed assessment for the tax year 2002 is lawful and proper.

### **DECISION**

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary for Administrative Tax Hearings finds the proposed assessment for the tax year 2002 to be lawful and proper and is hereby affirmed.

Taxpayer presents many arguments in defense of his 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 taxpayers who object to the payment of income tax. In fact, Taxpayer offered these same arguments to no avail at a previous administrative tax hearing with respect to similarly proposed individual income tax assessments for tax years 1999, 2000, and 2001. The arguments have consistently and uniformly been found to be completely lacking in legal merit and patently frivolous.

Taxpayer contends that he does 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 Taxpayer states by citing *U.S. v. Ballard*, 535 F.2d 400 (1976), 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 (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 *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 his position. None of the cases support his argument. 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 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.

Taxpayer contends that the Department of Revenue does not have the authority to change his return. Taxpayer argues that his federal taxable income for State income tax purposes must be the same as his federal taxable income for federal income tax purposes. Thus, Taxpayer contends that the State must use *zero* as Taxpayer’s federal taxable income in determining Taxpayer’s State income tax liability since his federal return reflects federal taxable income of *zero*. While it is true that the Department of Revenue does not have the authority to change or determine an individual’s federal income tax *liability*, the Department does have 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.

I find that the 2002 return filed by Taxpayer is frivolous within the meaning of the law and that all of Taxpayer’s arguments are without merit. Therefore, the proposed assessment for the tax year 2002 is hereby sustained in its entirety and is determined to be finally due and collectible.

Made and entered this 30th day of July, 2004.

Signature\_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue