

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 1997, )  
2000, 2001, and 2002 by the Secretary of )  
Revenue of North Carolina )  
vs. )  
Taxpayer )

**FINAL DECISION**  
Docket No. 2004-362

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on October 20, 2004, upon an application for hearing by Taxpayer, hereinafter referred to as "Taxpayer," wherein he protested the proposed assessments of additional income tax for the taxable years 1997 and 2002. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer; Nancy R. Pomeranz, Director of the Personal Taxes Division; Carl G. Hayes, Administrative Officer in the Personal Taxes Division; and, with Taxpayer's permission and at his request, an acquaintance of Taxpayer.

Pursuant to G.S. 105-241.1, assessments proposing additional tax, penalties, and interest for the tax years 1997, 2000, 2001, and 2002 were mailed to Taxpayer. Taxpayer filed a timely protest to the proposed assessments for tax years 1997 and 2002 and requested a hearing before the Secretary of Revenue. The administrative tax hearing included the proposed assessments for tax years 2000 and 2001 because the issues were the same as those present for tax years 1997 and 2002.

**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 1997, 2000, 2001, and 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 1997, a copy of which is designated as Exhibit PT-2.
3. Taxpayer's North Carolina individual income tax return for the taxable year 2002, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1997 dated October 28, 2003, a copy of which is designated as Exhibit PT-4.
5. Notice of Penalty Assessment for the taxable year 1997 dated December 17, 2003, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 2000 dated August 24, 2004, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for the taxable year 2001 dated August 24, 2004, a copy of which is designated as Exhibit PT-7.
8. Notice of Individual Income Tax Assessment for the taxable year 2002 dated April 6, 2004, a copy of which is designated as Exhibit PT-8.
9. Internal Revenue Service Report of Income Tax Examination Changes for the taxable year 1997 dated September 30, 2003, a copy of which is designated as Exhibit PT-9.
10. Internal Revenue Service Report of Income Tax Examination Changes for the taxable year 2000 dated February 4, 2004, a copy of which is designated as Exhibit PT-10.
11. Internal Revenue Service Report of Income Tax Examination Changes for the taxable year 2001 dated February 4, 2004, a copy of which is designated as Exhibit PT-11.
12. Taxpayer's wage and tax information for the taxable year 2002 from a business, a copy of which is designated as Exhibit PT-12.
13. Taxpayer's wage and tax information for the taxable years 2000 and 2001 from a business of which is designated as Exhibit PT-13.

14. Letter from the Department of Revenue's Central Examination Section to Taxpayer dated December 23, 2003, a copy of which is designated as Exhibit PT-14.
15. Letter from Taxpayer to the Department of Revenue's Correspondence Unit dated January 3, 2004, a copy of which is designated as Exhibit PT-15.
16. Letter from Jeffrey C. Davenport, Revenue Tax Auditor, to Taxpayer dated April 14, 2004, a copy of which is designated as Exhibit PT-16.
17. Letter from Taxpayer to the Department of Revenue's Correspondence Unit dated April 20, 2004, a copy of which is designated as Exhibit PT-17.
18. Letter from Taxpayer to the Department of Revenue's Correspondence Unit dated May 1, 2004, a copy of which is designated as Exhibit PT-18.
19. Letter from Julius P. Timberlake, Revenue Tax Auditor, to Taxpayer dated May 25, 2004, a copy of which is designated as Exhibit PT-19.
20. Letter from Carl G. Hayes, Administrative Officer in the Personal Taxes Division, to Taxpayer dated June 11, 2004, a copy of which is designated as Exhibit PT-20.
21. Letter from Taxpayer to Carl G. Hayes dated July 4, 2004, a copy of which is designated as Exhibit PT-21.
22. Letter from Taxpayer to Julius P. Timberlake dated July 29, 2004, a copy of which is designated as Exhibit PT-22.
23. Letter from Eugene J. Cella to Taxpayer dated August 17, 2004, a copy of which is designated as Exhibit PT-23.
24. Letter from Taxpayer to Nancy R. Pomeranz, Director of the Personal Taxes Division, dated August 30, 2004, a copy of which is designated as Exhibit PT-24.
25. Letter from Carl G. Hayes to Taxpayer dated September 15, 2004, a copy of which is designated as Exhibit PT-25.
26. Letter from Carl G. Hayes to Taxpayer dated October 5, 2004, a copy of which is designated as Exhibit PT-26.
27. Letter from Taxpayer to Carl G. Hayes dated October 12, 2004, a copy of which is designated as Exhibit PT-27.

Taxpayer was accompanied to the hearing by three acquaintances. The Assistant Secretary asked Taxpayer and his acquaintances to sign their names on a Sign-In Log, a copy of which is designated as Exhibit SR-1. Two of the acquaintances signed in as "Secured Party" and

refused to divulge their names. As a result, the Assistant Secretary dismissed the two before the hearing commenced.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary makes the following 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 filed his North Carolina income tax returns for the tax year 1997 and 2002 on September 17, 2000 and April 14, 2004, respectively. Taxpayer did not file North Carolina individual income tax returns for the tax years 2000 and 2001.
3. Taxpayer's 1997 and 2002 returns reflected federal taxable income and North Carolina taxable income of zero.
4. The Department of Revenue received a report from the Internal Revenue Service reflecting a determination that Taxpayer's federal taxable income was \$28,170.00 for tax year 1997. The amount was determined by subtracting the standard deduction of \$4,150.00 for a single individual and the personal exemption of \$2,650.00 from adjusted gross income of \$34,970.00. Taxpayer's North Carolina taxable income was determined by adding to federal taxable income the differences between the State and federal allowances for the standard deduction (\$3,000.00 compared to \$4,150.00) and the personal exemption (\$2,500.00 compared to \$2,650.00).
5. Pursuant to G. S. 105-241.1, a Notice of Individual Income Tax Assessment proposing an assessment of additional income tax, a twenty-five percent negligence penalty, and accrued interest for the tax year 1997 was mailed to Taxpayer on October 28, 2003. A Notice of Penalty Assessment proposing an assessment of the ten-percent late payment penalty for the tax year 1997 was mailed to Taxpayer on December 17, 2003.
6. The Department determined Taxpayer's North Carolina taxable income from information obtained from his employer, a business for tax year 2002. Taxpayer's income for 2002 was estimated to be \$34,865.00 and one personal exemption and the standard deduction for a single individual was allowed.
7. Pursuant to G. S. 105-241.1, a Notice of Individual Income Tax Assessment proposing an assessment of additional income tax, a twenty-five percent late filing penalty, a ten percent late payment penalty, a twenty-five percent negligence penalty, and accrued interest for the year 2002 was mailed to Taxpayer on April 6, 2004. On April 14, 2004, Taxpayer filed a 2002 North Carolina individual income tax return reflecting federal taxable income of zero, North Carolina taxable income of zero, and North Carolina tax withheld of zero.
8. The Department requested that the Assistant Secretary affirm the imposition of a penalty of \$500.00 for filing a frivolous return for the tax year 2002.

9. The Department received a report from the Internal Revenue Service reflecting a determination that Taxpayer's federal taxable income was \$33,785.00 for tax year 2000 and \$28,347.00 for tax year 2001. The amounts were determined based on a filing status of single and allowing the standard deduction and one personal exemption. Taxpayer's North Carolina taxable income for each year was determined by adding to federal taxable income the differences between the State and federal allowances for the standard deduction and personal exemption. North Carolina taxable income was determined to be \$30,882.00 for tax year 2000 and \$30,297.00 for tax year 2001.
10. Pursuant to G. S. 105-241.1, Notices of Individual Income Tax Assessment proposing assessments of additional income tax, a twenty-five percent late filing penalty, a ten percent late payment penalty, a twenty-five percent negligence penalty, and accrued interest for each tax year were mailed to Taxpayer on August 24, 2004. The proposed assessment for the tax year 2001 also included the penalty for underpayment of estimated income tax. Subsequent to the mailing of the proposed assessment for tax year 2000, additional information was obtained from Taxpayer's employer, indicating that North Carolina income tax of \$1,357.00 was withheld from Taxpayer's wages for tax year 2000.
11. Taxpayer objected to the proposed assessments for tax years 1997 and 2002 and timely requested a hearing before the Secretary of Revenue. On October 5, 2004, the Department notified Taxpayer that the administrative tax hearing would include the proposed assessments for tax years 2000 and 2001 because the issues are the same as those present for tax years 1997 and 2002.
12. Taxpayer contends that (1) he earned no income; (2) his compensation for services is not income and is excludable from taxation; (3) the Internal Revenue Code does not impose an income tax liability nor require that income be paid on the basis of a return; (4) no statute authorizes the Internal Revenue Service to change a return; and (5) income tax is voluntary and any assessment without a taxpayer's consent would be invalid and illegal.

### **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.
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. If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer is required to file a return with the Secretary of Revenue reflecting the corrected or determined taxable income. 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.
6. 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 can be imposed for tax year 2002 because the 2002 individual income tax return filed by Taxpayer satisfies both of these requirements.
7. 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.
8. The proposed assessments for tax years 1997, 2000, 2001, and 2002, modified to allow North Carolina income tax withheld of \$1,357.00 for tax year 2000, and to include the penalty of \$500.00 for filing a frivolous return for tax year 2002, are 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 assessments for tax years 1997, 2000, 2001, and 2002, to the extent hereinafter modified, to be lawful and proper and are hereby affirmed.

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 taxpayers 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.

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 the money or other form of payment that one receives from employment, business, investments, royalties, gifts, 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.

Taxpayer contends that income is limited to corporate profit and cites *Merchant's Loan and Trust Co. v. Smietanka*, 255 U.S. 509, in support of his position. This case does not support his argument. In *Merchant's*, 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. Therefore, the question of whether wages or other forms of compensation received by an individual are income was not at issue in this case. 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 any assessment without a taxpayer's consent would be invalid and illegal. 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 law clearly imposes a State income tax on Taxpayer and requires him to file a State income tax return.

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 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.

Taxpayer contends that no statute authorizes the Internal Revenue Service to change 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 Service has authority to adjust a taxpayer's federal income tax return; that issue is between Taxpayer and the Internal Revenue Service. However, I note that Chapter 63 of the Internal Revenue Code addresses federal assessments and deficiencies. It is clear from a reading of that section of the Code that the Internal Revenue Service is authorized to determine if the return filed by a taxpayer is correct and to assess any deficiency resulting from the taxpayer's errors. 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 all of Taxpayer's arguments are without merit. Therefore, the proposed assessments for tax years 1997, 2000, 2001, and 2002, modified to allow North Carolina income tax withheld of \$1,357.00 for tax year 2000 and to include the penalty of \$500.00 for filing a frivolous return for tax year 2002, are hereby sustained in their entireties and are determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 5th day of January, 2005.

Signature \_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue