

**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 2005, )  
by the Secretary of Revenue )  
of North Carolina )  
 )  
vs. )  
 )  
[Taxpayer 1] and [Taxpayer 2], Taxpayers )

**FINAL DECISION**  
Docket No. 2006-299

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon an application for hearing by [Taxpayer 1] and [Taxpayer 2], hereinafter referred to collectively as "Taxpayers" and separately as "Husband" and "Wife," respectively, wherein they objected to the proposed assessment of additional income tax for the taxable year 2005. At Taxpayers' request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayers until January 5, 2007, to provide any arguments, documents, or other evidence in support of their 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 and G.S. 105-159, a proposed assessment for the tax year 2005 was mailed to Taxpayers on August 29, 2006. Taxpayers timely requested a hearing before the Secretary of Revenue.

**ISSUES**

The issue to be decided in this matter is as follows:

Is the assessment for additional income tax proposed against Taxpayers for taxable year 2005 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 tax year 2005, with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the tax year 2005 dated August 29, 2006, a copy of which is designated as Exhibit PT-3.
4. Notice of Amended Individual Income Tax Assessment for the tax year 2005 dated October 5, 2006, a copy of which is designated as Exhibit PT-4.
5. Wage and income transcripts received from the Internal Revenue Service for tax year 2005, copies of which are collectively designated as Exhibit PT-5.
6. Letter from C. Y. Sawyer, former Revenue Officer in the Taxpayer Assistance Division, to Taxpayers dated May 11, 2006, a copy of which is designated as Exhibit PT-6.
7. Letter from Husband to Department of Revenue dated August 8, 2006, with related attachment, copies of which are collectively designated as Exhibit PT-7.
8. Letter from Stephanie Gray, Revenue Tax Auditor in the Examination Division, to Taxpayers dated August 29, 2006, a copy of which is designated as Exhibit PT-8.
9. Letter from Husband to Department of Revenue dated September 6, 2006, a copy of which is designated as Exhibit PT-9.
10. Letter from Husband to Stephanie Gray dated October 17, 2006, with related attachments, copies of which are collectively designated as Exhibit PT-10.
11. Taxpayers' copy of a letter from Rhonda R. Smith, Administrative Officer in the Personal Taxes Division, dated October 20, 2006, a copy of which is designated as Exhibit PT-11.
12. Letter from Husband to Rhonda R. Smith dated October 24, 2006, a copy of which is designated as Exhibit PT-12.

13. Letter from Eugene J. Cella to Taxpayers dated November 2, 2006, a copy of which is designated as Exhibit PT-13.
14. Letter from Husband to Eugene J. Cella dated November 7, 2006, a copy of which is designated as Exhibit PT-14.
15. Letter from Eugene J. Cella to Taxpayers dated November 9, 2006, a copy of which is designated as Exhibit PT-15.
16. Letter from Husband to Eugene J. Cella dated December 6, 2006, a copy of which is designated as Exhibit PT-16.

Husband submitted his response to the Department's position in his letter to Eugene J. Cella dated January 3, 2007, with related attachments, 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 2005 North Carolina individual income tax return requesting a refund of \$5,513.00.
3. Taxpayers did not submit copies of their wage and tax statements with their 2005 return since they contend the data listed was incorrect. Instead, Taxpayers submitted redacted copies of Federal Forms 4852, Substitute for Form W-2s, Wage and Tax Statements.
4. Taxpayers' 2005 return reflected a negative federal taxable income of \$15,039.00; North Carolina income tax of zero; and North Carolina tax withheld of \$5,513.00.
5. Based on federal wage and income transcripts for tax year 2005, Husband had wages and interest income of \$52,017.00 and \$11.00, respectively. Wife had wages, interest income, and retirement benefits of \$38,568.00, \$176.00, and \$1,182.00, respectively.
6. Upon examination, the Department calculated Taxpayers' 2005 federal taxable income to be \$75,554.00, which consisted of wages, interest income, and retirement benefits; the standard deduction for a married couple filing jointly; and two personal exemptions.

7. For the tax year 2005, North Carolina taxable income was determined to be \$80,954.00 by increasing federal taxable income by \$5,400.00 for the difference between the amounts allowed for the federal standard deduction and personal exemptions and the State deduction and personal exemptions.
8. A Notice of Individual Income Tax Assessment for the tax year 2005 reflecting a twenty-five percent negligence penalty and a frivolous return penalty was mailed to Taxpayers on August 29, 2006.
9. Taxpayers objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
10. Subsequent to mailing the assessment notice on August 29, 2006, the Department determined that the twenty-five percent negligence penalty was assessed in error. A Notice of Amended Individual Income Tax Assessment for the tax year 2005 was mailed to Taxpayers on October 5, 2006, reflecting only the portion of the frivolous return penalty that remains uncollected.
11. In error, no retirement deduction was allowed for Wife's retirement benefits of \$1,182.00. Taxpayers corrected North Carolina taxable income should be decreased to \$79,772.00.
12. Taxpayers contend that only they can decide the amount of "income", if any.
13. Taxpayers contend that the Internal Revenue Service has determined their taxable income to be "zero" based on the account transcript obtained from the Internal Revenue Service.
14. "Taxable income as determined under the Code" does not mean the taxable income a taxpayer chooses to report on his or her return, but rather the taxable income as it should be correctly calculated under the Code.
15. Taxpayers contend that (1) nowhere in the Code is the word "income" defined; (2) they are not "employees" and their pay does not constitute "wages" as defined in the revenue laws; (3) the Sixteenth Amendment does not authorize a direct non-apportioned federal income tax.
16. Taxpayers contend that they did not file a frivolous return for the tax year 2005.
17. Taxpayers' arguments were designed to avert attention away from the core issues. Taxpayers have presented no factual evidence to show that the Department's determination was not proper.

## CONCLUSIONS OF LAW

1. Division II of Article 4 in chapter 105 of the North Carolina General Statutes 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 or deriving income from gambling activities in this State.
2. "Taxpayer" is defined as an individual subject to tax imposed by Division II of Article 4 in Chapter 105.
3. "North Carolina taxable income" is defined as the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted as statutorily provided, for the differences in State and federal law.
4. Federal taxable income is defined in 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 interest. Wages, salaries, commissions paid salesmen, compensation for services on the basis of percentage of profits, tips, and bonuses are all includable in gross income.
5. An individual is required to file a federal income tax return if his gross income for the year equal or exceeds the allowable exemption amount.
6. A resident of this State is required under G.S. 105-152 to file a North Carolina individual income tax return. The North Carolina return shall show the taxable income and adjustments to federal income required by statute.
7. If a taxpayer does not provide adequate and reliable information upon which to compute his tax liability, G.S. 105-241.1 provides that 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 of up to \$500.00 can 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 seriousness. A penalty of \$500.00 was properly assessed for the tax year 2005 because the 2005 individual income tax return filed by Taxpayers satisfies both of these requirements.

9. The term “income” is not defined in the Internal Revenue Code, nor is it defined in the North Carolina Revenue Laws. Blacks Law Dictionary defines income as the 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. 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.
10. Internal Revenue Code section 3401 (c) establishes the general rule that “wages” include all remuneration for services performed by an employee for his employer and that the employer has a responsibility to withhold tax from “wages.” Section 3401 (c) further states that the term “employee” includes an officer, employee or elected official of the United States...” This language does not address how other employees’ wages are subject to withholding or taxation. Section 7701 (c) states that the use of the word “includes” “shall not be deemed to exclude other things otherwise within the meaning of the term defined.” Thus, the word “includes” as used in the definition of “employee” is a term of enlargement, not of limitation. It clearly makes federal employees and officials a part of the definition of “employee”, which generally includes private citizens
11. In *A. Ficalora*, CA-2, 85-1 USTC ¶9103, the Court held that Congress had the constitutional authority to impose an income tax on individuals. The court cited the United States Supreme Court’s decision in *Pollock* (157 U.S. 429), which explicitly stated that taxes on income from employment were not direct taxes and were not subject to the necessity of apportionment. In *United States v. Collins*, 920 F.2d 619, 629 (10<sup>th</sup> Cir. 1990), the court cited to *Brushaber v. Union Pacific R.R.*, 240 U.S. 1, 12-19 (1916), and noted that the U.S. Supreme Court has recognized that the “sixteenth amendment authorizes a direct nonapportioned tax upon United States citizens throughout the nation.” Furthermore, the Sixteenth Amendment granted Congress the power to lay and collect taxes on incomes, from whatever source derived, without apportionment. In *United States v. Gerads*, 999 F.2d 1255 (8<sup>th</sup> Cir. 1993), the Court stated “we have rejected on numerous occasions, the tax-protestor argument that the federal income tax is an unconstitutional direct tax that must be apportioned.”

**DECISION**

Taxpayers' contentions are shopworn arguments characteristic of tax-protestor rhetoric that has been uniformly rejected by the courts. Based on the foregoing evidence of record, finding of fact, and conclusion of law, the assessment proposed for the tax year 2005, modified to exclude Wife's retirement income, is hereby found to be lawful and proper and is determined to be finally due and collectible.

Made and entered this 12<sup>th</sup> day of March, 2007.

Signature \_\_\_\_\_

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings  
North Carolina Department of Revenue