

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 2003,)
2004, and 2005 by the Secretary of Revenue)
of North Carolina)
)
vs.)
)
[Taxpayers])

FINAL DECISION
Docket No. 2006-324

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, upon application for hearing by [Taxpayers], hereinafter referred to collectively as “Taxpayers” and separately as “Husband” and “Wife,” respectively, wherein they objected to the proposed assessments of additional income tax for the taxable years 2003, 2004, and 2005. At Husband’s request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayers until March 11, 2007, to provide any arguments, documents, or other evidence in support of their objection 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 and G.S. 105-159, assessments proposing additional tax, penalties, and accrued interest for tax years 2003, 2004, and 2005, were mailed to Taxpayers. Taxpayers objected to the proposed assessments and timely requested a 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 2003, 2004, and 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 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 2003 with related attachments, copies of which are collectively designated as Exhibit PT-2.
3. Taxpayers' North Carolina individual income tax return for taxable year 2004 with related attachments, copies of which are collectively designated as Exhibit PT-3.
4. Taxpayer's North Carolina individual income tax return for taxable year 2005 with related attachments, copies of which are collectively designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for taxable year 2003 dated May 9, 2006, a copy of which is designated as Exhibit PT-5.
6. Notice of Amended Individual Income Tax Assessment for taxable year 2003 dated November 3, 2006, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for taxable year 2003 dated November 7, 2006, a copy of which is designated as Exhibit PT-7.
8. Notice of Individual Income Tax Assessment for taxable year 2004 dated October 24, 2006, a copy of which is designated as Exhibit PT-8.
9. Notice of Individual Income Tax Assessment for taxable year 2005 dated October 24, 2006, a copy of which is designated as Exhibit PT-9.
10. Internal Revenue Service CP 2000 match information for taxable year 2003, a copy of which is designated as Exhibit PT-10.
11. Husband's wage and tax statement from his employer for tax year 2003, a copy of which is designated as Exhibit PT-11.
12. Husband's Internal Revenue Service Wage and Income Transcript for tax year 2004 dated October 19, 2006, a copy of which is designated as Exhibit PT-12.

13. Husband's Internal Revenue Service Wage and Income Transcript for tax year 2005 dated October 19, 2006, a copy of which is designated as Exhibit PT-13.
14. Wife's Internal Revenue Service Wage and Income Transcript for tax year 2004 dated October 19, 2006, a copy of which is designated as Exhibit PT-14.
15. Letter from E. K. Maxie, Revenue Tax Auditor, to Taxpayers dated July 27, 2005, a copy of which is designated as Exhibit PT-15.
16. Response to letter from E. K. Maxie to Husband's employer, dated July 27, 2005, a copy of which is designated as Exhibit PT-16.
17. Response to letter from E. K. Maxie to Husband's employer, dated July 27, 2005, a copy of which is designated as Exhibit PT-17.
18. Letter from Husband to Department of Revenue dated October 13, 2006, a copy of which is designated as Exhibit PT-18.
19. Letter from Edward S. Koonce, Administrative Officer in the Personal Taxes Division, to Taxpayers dated November 3, 2006, a copy of which is designated as Exhibit PT-19.
20. Letter from E. K. Maxie to Taxpayers dated November 8, 2006, a copy of which is designated as Exhibit PT-20.
21. Letter from Husband to Department of Revenue dated November 21, 2006, a copy of which is designated as Exhibit PT-21.
22. Letter from Husband to Department of Revenue dated November 21, 2006, a copy of which is designated as Exhibit PT-22.
23. Letter from Husband to Department of Revenue dated November 21, 2006, a copy of which is designated as Exhibit PT-23.
24. Letter from Edward S. Koonce to Taxpayers dated December 6, 2006, a copy of which is designated as Exhibit PT-24.
25. Letter from Eugene J. Cella to Taxpayers dated December 6, 2006, a copy of which is designated as Exhibit PT-25.
26. Letter from Husband to Eugene J. Cella dated December 14, 2006, a copy of which is designated as Exhibit PT-26.
27. Letter from Eugene J. Cella dated December 19, 2006, a copy of which is designated as Exhibit PT-27.

28. Letter from Husband to Edward S. Koonce dated January 3, 2007, a copy of which is designated as Exhibit PT-28.
29. Letter from Husband to Department of Revenue dated January 3, 2007, a copy of which is designated as Exhibit PT-29.
30. Letter from Husband to Edward S. Koonce dated January 4, 2007, a copy of which is designated as Exhibit PT-30.

Husband submitted Brief for Tax Hearing with related attachments and cover letter to Eugene J. Cella dated March 8, 2007, 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 tax years 2003, 2004, and 2005.
3. Taxpayers' returns reflected federal taxable income of zero, North Carolina income tax of zero, and North Carolina income tax withheld of \$1,542.00 and \$788.00 for tax years 2004 and 2005, respectively. Taxpayers requested refunds of \$1,542.00 and \$788.00 for tax years 2004 and 2005, respectively.
4. Husband's wage and income information from the Internal Revenue Service for tax year 2003 reflected wages of \$32,551.00 and 1099 miscellaneous income of \$83,034.00.
5. Husband's wage and tax information received for tax year 2003 from his employer, reflected North Carolina income tax withheld of \$1,459.00.
6. Husband's wage and tax information received for tax year 2004 from his employers, reflected North Carolina income tax withheld of \$730.00 and \$444.00, respectively.
7. Husband's wage and income information received from the Internal Revenue Service for tax year 2004, reflected wages of \$27,679.00 and 1099 miscellaneous income of \$75,990.00.

8. Husband's wage and income information received from the Internal Revenue Service for tax year 2005, reflected wages of \$18,847.00 and 1099 miscellaneous income of \$85,344.00.
9. Wife's wage and income information received from the Internal Revenue Service for tax year 2005 reflected wages of \$671.00 and 1099 miscellaneous income of \$2,700.00.
10. An assessment proposing additional tax, penalties, and interest for tax year 2003 was mailed to Taxpayers on May 9, 2006. Assessments proposing additional tax, penalties, and interest for tax years 2004 and 2005 were mailed to Taxpayers on October 24, 2006.
11. Subsequent to the mailing of the proposed assessment for tax year 2003, the Department determined that Taxpayers were entitled to an additional personal exemption. Corrected notices proposing a reduction in the additional tax, penalties, and interest for tax year 2003 were mailed to Taxpayers on November 3 and 7, 2006.
12. The notices for tax years 2003, 2004, and 2005 proposed additional income tax, a ten percent late payment penalty, a \$500.00 frivolous return penalty, and accrued interest. In addition, the notice for tax year 2004 proposed a negligence penalty and a penalty for underwithholding. The notice for tax year 2005 also proposed a negligence penalty.
13. The Department requested that the Assistant Secretary impose a 25% negligence penalty for tax year 2003.
14. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
15. Taxpayers contend that (1) they do not have income because the Internal Revenue Service does not define "income"; (2) the Department of Revenue has no authority to correct their federal return; (3) no employee of the Department of Revenue has the authority to change their return as it was filed; (4) income is limited to corporate profits, (5) the Internal Revenue Code does not impose an income tax liability, and; (6) the income tax is voluntary and taxpayers are the only ones who can "self-assess" the tax.
16. Taxpayers offered similar arguments to no avail in four previous administrative tax hearings with respect to individual income tax assessments proposed against them for tax years 1999 through 2002.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following 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.
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 a 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 in section 61 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 a percentage of profits, tips, and bonuses are all includable in gross income.
5. Internal Revenue Code section 63 allows a taxpayer who does not claim itemized deductions to claim the standard deduction. The basic standard deduction for each filing status is set out in subsection (c)(2). For married individuals, the basic standard deduction is \$6,000. Subsection (c)(4) provides that the basic standard deduction is increased each year for inflation.
6. Internal Revenue Code section 151 allows a taxpayer to claim an exemption for himself and for each qualifying dependent. Subsection (d)(1) provides that the basic exemption amount is \$2,000. Subsection (d)(4) provides that the basic exemption amount is increased each year for inflation.
7. An individual is required to file a federal return if his gross income for the year equals or exceeds the allowable exemption amount.
8. A resident of this State is required to file a North Carolina individual income tax return. The North Carolina return must show the taxable income and adjustments to federal taxable income required by statute.

9. The Secretary of Revenue has the power to examine any books, papers, records, or other relevant data for the purposes 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.
10. 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.
11. 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.
12. Taxpayers contend that they do 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 Taxpayers state 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 decision in *Ballard* does not support Taxpayers' position that they have 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 includable in gross income.
13. Taxpayers argue that their federal taxable income for State income tax purposes must be the same as their federal taxable income for federal income tax purposes. Thus, Taxpayers contend that the State must use zero as Taxpayers' federal taxable income in determining Taxpayers' State income tax liability since their 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 the purposes of determining the individual's North Carolina income tax liability. 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 the information other than that provided on a taxpayer's federal return to determine what taxes are actually owed to the State.

14. Taxpayers contend that income is limited to corporate profit and cite 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 their position. None of the cases support their 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 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.
15. Taxpayers contend 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.
16. 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 the Taxpayer and the Internal Revenue Service. State law clearly and

unequivocally imposes a State income tax on Taxpayers and requires them to file a State income tax return.

17. A penalty is imposed for failure to pay tax when due. The penalty is equal to ten percent of the tax (minimum \$5.00).
18. 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.
19. A penalty is 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 that 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. Because Taxpayers' returns satisfy both of these requirements, a penalty of \$500.00 has been properly imposed.

DECISION

Taxpayers raise familiar arguments typically presented to the Department of Revenue by individuals who object to the payment of income tax. Taxpayers' contentions are shopworn arguments characteristic of tax-protestor rhetoric that have been uniformly rejected by the courts. Unfortunately, four previous adverse decisions have not been sufficient to deter them from making a similar frivolous position in this case.

Based on the foregoing findings of fact and conclusions of law, the proposed assessments of additional tax, penalties, and interest for tax years 2003, 2004, and 2005, modified to include the negligence penalty and to reduce the failure to pay penalty for tax year 2003, are found to be lawful and proper. The assessments are, therefore, sustained in their entireties and are determined to be finally due and collectible, together with interest as allowed by law.

Made and entered this 18th day of May, 2007.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue