STATE OF NORTH CAROLINA **BEFORE THE SECRETARY OF REVENUE**

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessments of Additional Income Tax for the Taxable Years 1999 and 2000 by the Secretary of Revenue of North Carolina	)	**FINAL DECISION** Docket No. 2002-208
vs.	)	
[Taxpayer]	)	

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on June 10, 2002, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessments of additional income tax for the taxable years 1999 and 2000. The hearing was held by the Assistant Secretary under the provisions of G.S. 105-260.1 and was attended by Taxpayer and Nancy R. Pomeranz, Director of the Personal Taxes Division.

Pursuant to G.S. 105-241.1, assessments proposing additional tax and penalties for the tax years 1999 and 2000 were mailed to Taxpayer on December 13, 2001. Taxpayer filed a timely protest to the proposed assessments and 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 Taxpayer for the taxable years 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 of Administrative 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 1999, with related attachments, copies of which are collectively designated as Exhibit PT-2.

3. Taxpayer's North Carolina individual income tax return for the taxable year 2000, with related attachments, copies of which are collectively designated as Exhibit PT-3.

4. Notice of Individual Income Tax Assessment for the taxable year 1999 dated December 13, 2001, a copy of which is designated as Exhibit PT-4.

5. Notice of Individual Income Tax Assessment for the taxable year 2000 dated December 13, 2001, a copy of which is designated as Exhibit PT-5.

6. Federal income tax return detail information provided to the Department of Revenue on magnetic tape by the Internal Revenue Service for the taxable year 1999, a copy of which is designated as Exhibit PT-6.

7. Taxpayer's wage earnings information from the Employment Security Commission dated May 15, 2002, a copy of which is designated as Exhibit PT-7.

8. Letter from Central Examination Section – RAL to Taxpayer dated December 13, 2001, a copy of which is designated as Exhibit PT-8.

9. Letter from Taxpayer to Department of Revenue dated January 9, 2002, a copy of which is designated as Exhibit PT-9.

10. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayer dated January 28, 2002, a copy of which is designated as Exhibit PT-10.

11. Reply from Taxpayer to Patrick G. Penny received on March 13, 2002, a copy of which is designated as Exhibit PT-11.

12. Letter from Eugene J. Cella to Taxpayer dated March 19, 2002, a copy of which is designated as Exhibit PT-12.

13. Letter from Taxpayer to Department of Revenue received on March 27, 2002, a copy of which is designated as Exhibit PT-13.

14. Letter from Eugene J. Cella to Taxpayer dated April 17, 2002, a copy of which is designated as Exhibit PT-14.

At the hearing, Taxpayer presented a large binder of assorted documents, 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 individual income tax return for the tax year 2000. The Department of Revenue received Taxpayer's 1999 income tax return on December 8, 2000.

3. Taxpayer's 1999 and 2000 returns reflected federal taxable income of zero and North Carolina income tax of zero. The 1999 return reflected North Carolina tax withheld of $614.00. The 2000 return reflected North Carolina tax withheld of $92.00. Taxpayer requested refunds of $614.00 and $92.00 for the tax years 1999 and 2000, respectively.

4. Upon examination, the Department of Revenue calculated Taxpayer's federal taxable income for the tax year 1999 to be $5,997.00, consisting of wages of $13,047.00 based on information received from the Internal Revenue Service; the standard deduction for single; and one personal exemption. The Department of Revenue calculated Taxpayer's federal taxable income for the tax year 2000 to be negative $874.00, consisting of wages of $6,326.00 based on a report obtained from the Employment Security Commission; the standard deduction for single; and one personal exemption.

5. Taxpayer's North Carolina taxable income for the tax years 1999 and 2000 was determined to be $7,547.00 and $826.00, respectively, by adding to the corrected federal taxable income the amounts the federal standard deduction for single and the personal exemption had increased for inflation.

6. Taxpayer understated taxable income by twenty-five percent or more of gross income for both years.

7. Pursuant to G.S. 105-241.1, Notices of Individual Income Tax Assessment reflecting additional tax and penalties for the tax years 1999 and 2000 were mailed to Taxpayer on December 13, 2001. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.

8. Subsequent to receiving the hearing request, the Department of Revenue determined that additional wages of $6,283.00 earned by Taxpayer during 2000 were not included in the Department's calculation of federal taxable income for that year. The inclusion of the additional wages will result in additional tax due for the tax year 2000, upon which a twenty-five percent negligence penalty is applicable.

9. Taxpayer contends that (1) Taxpayer earned no income; (2) as a citizen of the United States, none of the sources of income identified in Code section 861 and its accompanying regulations apply to Taxpayer; therefore, he did not receive "income from whatever source derived"; (3) the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return; (4) income tax is voluntary and taxpayers are the only ones who can "self-assess" the tax; and (5) the State has delegated its power of taxation to the United States Congress in violation of the North Carolina Constitution.

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 (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. 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 $1,550.00 and $1,700.00 were properly made for the tax years 1999 and 2000, respectively.

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. 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 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 in seriousness. Penalties of $500.00 were properly assessed for the tax years 1999 and 2000 because the 1999 and 2000 individual income tax returns filed by Taxpayer satisfy 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. A penalty of $84.00 is due for the tax year 2000 as a result of the inclusion of the additional wages of $6,283.00 earned by Taxpayer during 2000.

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 assessments for the tax years 1999 and 2000, modified to include additional wages of $6,283.00 and the negligence penalty for the tax year 2000, 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 assessment for the tax year 1999 and the proposed assessment for the tax year 2000, 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 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. Taxpayer's arguments include (1) Taxpayer earned no income; (2) as a citizen of the United States, none of the sources of income identified in Code section 861 and its accompanying regulations apply to Taxpayer; therefore, he did not receive "income from whatever source derived"; (3) the Internal Revenue Code does not impose an income tax liability nor require that income tax be paid on the basis of a return; (4) income tax is voluntary

and taxpayers are the only ones who can "self-assess" the tax; and (5) the State has delegated its power of taxation to the United States Congress in violation of the North Carolina Constitution.

Taxpayer contends that he does not have income because the Internal Revenue Code ("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 Code, nor is it defined in the North Carolina Revenue Laws. However, 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 *Eisner v. Macomber,* 252 U.S. 189 (1920), *Merchant's Loan and Trust Co. v. Smietanka,* 255

U.S. 509 (1921), *Doyle v. Mitchell Brothers*, 247 U.S. 179 (1918), *Stratton's Independence v. Howbert*, 231 U. S. 399 (1913), and *Southern Pacific v. Lowe*, 247 U.S. 330 (1918), in support of his position. None of the cases support his argument. In *Eisner,* the court held that stock dividends are not income and hence are not taxable as such. The basis for the court's decision is that the shareholder received nothing as a result of the stock dividend for his separate use and benefit; on the contrary, every dollar of his investment remained the property of the company. The court defined income as "the gain derived from capital, from labor, or from both combined…." In *Commissioner of Internal Revenue v. Glenshaw Glass Co.,* 348 U.S. 426; 99 L.Ed. 483 (1955), the court concluded that *Eisner* was not meant to provide a touchstone to all future gross income questions. A taxpayer is taxable on "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." The statutory definition of gross income is "all-inclusive." 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 imply 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 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. (See *Lonsdale v. U.S.*, 919 F.2d 1440; 90-2 USTC (CCH) ¶ 50, 581, *McKinley v. U.S.*, 70 A.F.T.R.2d (RIA) 5805; 92-2 USTC (CCH) ¶ 50, 509, *Ficalora v. Commissioner of Internal Revenue*, 751 F.2d 85; 85-1

USTC (CCH) ¶ 9103, *Stelly v. Commissioner of Internal Revenue*, 761 F.2d 1113; 85-1 USTC (CCH) ¶ 9436, *Coleman v. Commissioner of Internal Revenue,* 791 F.2d 68 (7th Cir. 1986).) There are many other cases that could be cited. Taxpayer has cited none that rule otherwise.

Taxpayer correctly states that Code section 61 defines gross income as all income from whatever source derived. Taxpayer then attempts to define "source" and contends that Code section 861 and its accompanying statutes and regulations indicate that he is not subject to income tax on his wages because, as a citizen of the United States, he has no sources of income for purposes of the income tax. According to Taxpayer's argument, the only individuals subject to income tax on wages would be nonresident aliens. Such is not the case. For a citizen of the United States, the source of income is irrelevant. In *Glenshaw Glass Co.*, 348 U.S. 426; 99 L. Ed. 483 (1955), the court concluded that income tax is imposed on "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" with no restrictions as to "sources." 26 CFR 1.1-1(b) provides that "in general, all citizens of the United States, wherever resident, and all resident alien individuals, are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States." In addition, the term "from whatever source derived" in Code section 61 is not intended to be restrictive; instead, it is intended to be all encompassing. In *United States v. Buras*, 633 F.2d 1356, 1361 (9th Cir. 1980), the court stated "According to Buras, income must be derived from some source. …[T]he Sixteenth Amendment is broad enough to grant Congress the power to collect an income tax regardless of the source of the taxpayer's income." In *Angstadt v. Internal Revenue Service*, 99-2 USTC (CCH) ¶ 50, 926; 84 A.F.T.R.2d (RIA) 6776, the court stated "By the terms of the Sixteenth Amendment and section 61(a), 'source' is not to be a limitation on taxable income. Rather, income is to be taxed regardless of its source."

Code section 861 itself provides that the income of most citizens is from sources within the United States. Section 861(a) lists items of gross income that are treated as income from sources within the United States. Item (3) is compensation for labor or personal services

performed in the United States. 26 CFR 1.861-4(a)(1) states that "gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment…." In *Aiello v. Commissioner*, T.C. Memo 1995-40; 69 T.C.M. (CCH) 1765, the court stated "Apparently, petitioner believes that the only sources of income for purposes of section 61 are listed in section 861, that income from sources within the United States is taxed only to nonresident aliens and foreign corporations…. Under section 61(a)(1) and (4), petitioner clearly is required to include his wages, tokes, and interest in gross income."

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 liability 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. More importantly, since a North Carolina income tax liability is at issue, G.S. 105-134 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. A resident of this State is required under G.S. 105-152 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. The law

clearly and unequivocally imposes a State income tax on Taxpayer and requires him to file a State income tax return.

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 State is in violation of the North Carolina Constitution because a taxpayer's North Carolina taxable income means the taxpayer's taxable income as determined under the Internal Revenue Code. Section 2(1) of Article V of the Constitution provides in pertinent part that the "power of taxation…shall never be surrendered, suspended, or contracted away." To adopt by reference future amendments to the Code would likely be held to be an unconstitutional delegation of legislative power. Taxpayer's argument fails, however, because the State's reference to the Code does not automatically adopt future changes to the Code. G.S. 105-228.90 defines "Code" by referring to the Code as of a specific date. The definition is revised as needed to reflect the General Assembly's decision to adopt amendments to the Code. The General Assembly always uses a reference date equal to or prior to the date the legislation is enacted to ensure that it is not delegating its power to tax to the United States Congress.

I find that the 1999 and 2000 returns filed by Taxpayer are frivolous within the meaning of the law and that all of Taxpayer's arguments are without merit. Therefore, the proposed assessments for the tax years 1999 and 2000, modified to increase North Carolina taxable income by the additional wages of $6,283.00 and to assert a negligence penalty of $84.00 for the tax year 2000, 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 31st day of July, 2002.

Signature_____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue