

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)
1989 through 1992 by the Secretary of Revenue)
of North Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 99-351

This matter was heard before the Assistant Secretary of Revenue of North Carolina, Eugene J. Cella, upon an application for a hearing by [Taxpayer], wherein he protested the proposed assessments of individual income tax, penalties, and interest for the taxable years 1989 through 1992. At Taxpayer's request, the hearing was conducted via written communication and the Assistant Secretary allowed Taxpayer until April 20, 2001, to provide any arguments, documents, or other evidence in support of his objection to the assessments. The hearing was conducted by the Assistant Secretary under the provisions of G.S. 105-260.1.

ISSUES

The issues to be decided in this matter are as follows:

1. Is Taxpayer's retirement income received while he is an enrolled member of [a Native American Tribe] and living on the reservation subject to North Carolina income tax? If decided in the affirmative, is any portion of Taxpayer's retirement income considered to be associated with activities he performed on the reservation?
2. Is Taxpayer's rental income and loss from property located in another state; wages received for working in other states; and strike benefits received while Taxpayer was an enrolled member residing on the reservation subject to North Carolina income tax?
3. Are the individual income tax assessments proposed against Taxpayer for the taxable years 1989 through 1992 lawful and proper?

EVIDENCE

Evidence presented by W. Edward Finch, Jr., Administrative Officer in the Personal Taxes Division, consisted of the following:

1. Memorandum dated March 13, 2001, from E. Norris Tolson, Secretary of Revenue, to Marilyn R. Mudge, Acting Assistant Secretary of Administrative Hearings, a copy of which is designated as Exhibit PT-1.
2. Notice of Individual Income Tax Assessment for the taxable year 1989 dated February 21, 1999, a copy of which is designated as Exhibit PT-2.
3. Notice of Individual Income Tax Assessment for the taxable year 1990 dated February 21, 1999, a copy of which is designated as Exhibit PT-3.
4. Notice of Individual Income Tax Assessment for the taxable year 1991 dated February 21, 1999, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1992 dated February 21, 1999, a copy of which is designated as Exhibit PT-5.
6. Notice of Amended Individual Income Tax Assessment for the taxable year 1990 dated July 26, 1999, a copy of which is designated as Exhibit PT-6.
7. Notice of Amended Individual Income Tax Assessment for the taxable year 1991 dated July 26, 1999, a copy of which is designated as Exhibit PT-7.
8. Notice of Amended Individual Income Tax Assessment for the taxable year 1992 dated July 26, 1999, a copy of which is designated as Exhibit PT-8.
9. Field Auditor's Report for the taxable year 1989 dated February 1, 1999, a copy of which is designated as Exhibit PT-9.
10. Field Auditor's Report for the taxable year 1990 dated February 1, 1999, a copy of which is designated as Exhibit PT-10.
11. Field Auditor's Report for the taxable year 1991 dated February 1, 1999, a copy of which is designated as Exhibit PT-11.
12. Field Auditor's Report for the taxable year 1992 dated February 1, 1999, a copy of which is designated as Exhibit PT-12.
13. Taxpayer's federal individual income tax return for the taxable year 1989, a copy of which is designated as Exhibit PT-13.
14. Taxpayer's federal individual income tax return for the taxable year 1990, a copy of which is designated as Exhibit PT-14.
15. Taxpayer's Forms 1099-R for the taxable year 1991, a copy of which is designated as Exhibit PT-15.

16. Taxpayer's federal individual income tax return for the taxable year 1992, a copy of which is designated as Exhibit PT-16.
17. Letter from L. B. DeWeese, Revenue Field Auditor in the Field Examination Division, to Taxpayer dated May 26, 1998, a copy of which is designated as Exhibit PT-17.
18. Letter from L. B. DeWeese to Taxpayer dated July 30, 1998, a copy of which is designated as Exhibit PT-18.
19. Letter from Taxpayer to L. B. DeWeese dated February 26, 1999, a copy of which is designated as Exhibit PT-19.
20. Undated letter with attachments from Taxpayer to Nancy R. Pomeranz, Director of the Personal Taxes Division, copies of which are collectively designated as Exhibit PT-20.
21. Letter from W. Edward Finch, Jr., to Taxpayer dated July 21, 1999, a copy of which is designated as Exhibit PT-21.
22. Letter from Taxpayer to W. Edward Finch, Jr., dated August 9, 1999, a copy of which is designated as Exhibit PT-22.
23. Letter from W. Edward Finch, Jr., to Taxpayer dated September 2, 1999, a copy of which is designated as Exhibit PT-23.
24. Letter from Taxpayer to W. Edward Finch, Jr., dated September 20, 1999, a copy of which is designated as Exhibit PT-24.
25. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Taxpayer dated September 28, 1999, a copy of which is designated as Exhibit PT-25.
26. Letter from Michael A. Hannah to Taxpayer dated December 14, 1999, a copy of which is designated as Exhibit PT-26.
27. Letter from W. Edward Finch, Jr., to Taxpayer dated December 20, 1999, a copy of which is designated as Exhibit PT-27.
28. Letter from W. Edward Finch, Jr., to Taxpayer dated February 3, 2000, a copy of which is designated as Exhibit PT-28.
29. Letter from Michael A. Hannah to Taxpayer dated February 11, 2000, a copy of which is designated as Exhibit PT-29.
30. Letter from Michael A. Hannah to Taxpayer dated March 17, 2000, a copy of which is designated as Exhibit PT-30.

In lieu of appearing at the hearing, Taxpayer requested that the hearing be conducted by mail. The Assistant Secretary granted Taxpayer's request and allowed Taxpayer until April 20, 2001 to submit for the record arguments, documents, or other evidence in support of his objections to the proposed assessments.

The Assistant Secretary entered the following evidence into the record:

1. Letter and related attachments from [Taxpayer's Attorney] to Michael A. Hannah dated June 19, 2000, copies of which are collectively designated as Exhibit S-1.
2. Letter from [Taxpayer's Attorney] to Michael A. Hannah dated June 23, 2000, a copy of which is designated as Exhibit S-2.
3. Letter and related attachments from Michael A. Hannah to [Taxpayer's Attorney] dated September 1, 2000, copies of which are collectively designated as Exhibit S-3.
4. Letter from Michael A. Hannah to [Taxpayer's Attorney] dated November 10, 2000, a copy of which is designated as Exhibit S-4.
5. Letter from Michael A. Hannah to [Taxpayer's Attorney] dated November 30, 2000, a copy of which is designated as Exhibit S-5.
6. Letter from [Taxpayer's Attorney] to Michael A. Hannah dated January 16, 2001, a copy of which is designated as Exhibit S-6.
7. Letter from [Taxpayer's Attorney] to W. Edward Finch, Jr., dated February 9, 2001, a copy of which is designated as Exhibit S-7.
8. Letter from Marilyn R. Mudge, Acting Assistant Secretary of Administrative Hearings to [Taxpayer's Attorney] dated March 14, 2001, a copy of which is designated as Exhibit S-8.
9. Letter from W. Edward Finch, Jr., to [Taxpayer's Attorney] dated April 9, 2001, a copy of which is designated as Exhibit S-9.
10. Letter from [Taxpayer's Attorney] to Marilyn R. Mudge dated April 12, 2001, a copy of which is designated as Exhibit S-10.
11. Letter from Marilyn R. Mudge to [Taxpayer's Attorney] dated May 3, 2001, a copy of which is designated as Exhibit S-11.

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 during the taxable years at issue was an enrolled member of [a Native American Tribe] living on the reservation.
2. Taxpayer did not file North Carolina individual income tax returns for the tax years 1989 through 1992 although requested to do so by the examining auditor.
3. Based on copies of Taxpayer's federal income tax returns and copies of Forms 1099R, W-2P, and W-2 obtained from the Internal Revenue Service, the auditor determined

Taxpayer's North Carolina taxable income to be \$9,111.13, \$43,918.63, \$44,011.09, and \$48,153.79 for the tax years 1989, 1990, 1991, and 1992, respectively. In determining North Carolina taxable income, the auditor did not deduct any amounts for income derived from activities on the reservation. The auditor asserted the 10 percent late-payment penalty, the 25 percent late-filing penalty, and the 10 percent negligence penalty. The auditor also asserted the penalty for underpayment of estimated income tax for tax years 1990, 1991, and 1992.

4. Notices of Individual Income Tax Assessment for the tax, penalties, and interest determined by the auditor for the tax years 1989 through 1992 were mailed to Taxpayer on February 21, 1999. Taxpayer objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.
5. Subsequent to receiving Taxpayer's hearing request, it was determined that the auditor had incorrectly computed the penalties for underpayment of estimated income tax. The correct penalties for tax years 1990, 1991, and 1992 are \$32.80, \$150.63, and \$148.16, respectively. Notices of Amended Individual Income Tax Assessment reflecting the corrected penalties were mailed to Taxpayer on July 26, 1999.
6. Taxpayer was employed as a commercial airline pilot for [an airline]; hereinafter referred to as "Employer" until its bankruptcy in 1989. Taxpayer participated in an arrangement whereby he would be "on call" by Employer while at home on the reservation. During such times, Taxpayer would be accessible by telephone or pager in case he was needed for back up flying because of bad weather, sickness, or other unanticipated circumstances. Taxpayer was "on call" approximately two weeks each month. Taxpayer contends that a portion of his retirement income received from Employer's pension plan that relates to wages received while being "on call" is considered as associated with activities on the reservation and consequently is not taxable.
7. During his career as an airline pilot, Taxpayer primarily flew out of [out-of-state airports]. Taxpayer did not fly from North Carolina airports. Taxpayer also worked extended periods of time as an instructor for Employer.
8. Taxpayer participated in Employer's pension plan for the entire period of his employment. In the taxable year 1990, Taxpayer received a distribution of \$251,483.14 from Employer's pension plan. Taxpayer rolled \$170,000.00 into an Individual Retirement Account and retained \$81,483.14. Taxpayer withdrew \$97,365.63 from the Individual Retirement Account in 1991 and the remainder of \$71,834.00 in 1992.
9. During the taxable years at issue, Taxpayer operated a hotel business located on the Reservation. Taxpayer also had rental income and losses from various rental properties, two of which were located in [another state], two on the Reservation, and one in North Carolina, but off the Reservation. Taxpayer reported capital losses of \$3,000.00 and \$530.00 on the 1989 and 1990 federal returns respectively, from the disposition of hotel equipment and improvements. Taxpayer received wages from Employer of \$9,737.23 in taxable year 1989 and strike benefits of \$20,800.00 and \$4,067.00 in the taxable years 1989 and 1990, respectively.
10. Taxpayer received annuity income of \$8,399.10, \$8,501.76, and \$708.48 during the taxable years 1990, 1991, and 1992, respectively. In tax year 1992, Taxpayer also

received a distribution of \$7,793.28 from Employer's pension plan for his share of a recovery resulting from a suit brought by the pension plan against a third party.

11. Taxpayer received interest income during all tax years at issue.
12. Taxpayer contends that retirement income is intangible income and as such is not subject to North Carolina income tax because it has situs on the reservation where Taxpayer resides.
13. Taxpayer contends that because he is an enrolled member residing on the reservation, the State is prohibited from taxing his income from activities outside the State such as rental income from property located in another state or wages and strike benefits received for working in another state.
14. Subsequent to requesting the hearing, Taxpayer furnished information establishing the location of his business and rental activities during the taxable years at issue. Consequently, the proposed assessments must be amended to exclude the business and rental income and losses from activities on the reservation and to exclude intangible income such as interest and individual retirement account distributions.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Acting Assistant Secretary of Revenue makes the following conclusions of law:

1. For residents of this State, North Carolina taxable income is defined as federal taxable income, adjusted for differences in State and federal law.
2. As a result of the Court's decision in *Eastern Band of Cherokee Indians v. North Carolina Department of Revenue*, North Carolina cannot tax income that is (i) earned or received by an enrolled member of a federally recognized Indian tribe and (ii) derived from activities on a federally recognized Indian reservation while the member resides on the reservation. Therefore, any such income included in federal taxable income must be deducted in arriving at North Carolina taxable income.
3. The taxable situs of intangible property, such as bank deposits, stocks, bonds, etc., which has not acquired a "business" situs, is considered to be the residence of the owner if the owner is an individual. Such intangible income received by an enrolled member of [a Native American Tribe] while the member resided on the reservation is deductible from federal taxable income. Therefore, Taxpayer's interest income is not subject to State income tax.
4. Retirement income is distinguishable from intangible income such as dividends or interest on bank deposits because it is paid in connection with past services. Unlike most intangible income, the situs of retirement income may be determined according to where the services were performed during the time contributions were being made to the retirement plan. On January 10, 1996, the United States Congress enacted The State Taxation Pension Income Act of 1995 which prohibits a state from taxing the pension income of any individual who is not a resident of the state. Previously, some states taxed former residents on such retirement income because they considered it to be in

connection with activity performed in the state. The taxing limitations imposed on states by the federal law apply to nonresidents and do not extend to members residing on the reservation who are otherwise residents of the state.

5. Retirement income associated with activities performed on the reservation is considered to be income derived from activities on the reservation and consequently is not taxable. Conversely, retirement income associated with activities performed off the reservation is taxable. Time spent by Taxpayer while “on call” for Employer on the reservation does not constitute activity performed on the reservation since the services for which he was ultimately paid were conducted off the reservation. The net distribution of \$81,483.00 from Employer’s pension plan and the annuity of \$5,667.84 both received by Taxpayer in 1990 represent retirement income derived from activities conducted off the reservation and are taxable.
6. Former section .1747, subchapter 6B, title 17 of the North Carolina Administrative Code provided in part: “Income from intangibles and retirement income received by an enrolled member residing on the reservation is...considered exempt.” Notwithstanding the former rule, the Department has consistently treated the retirement income associated with activities off the reservation of members residing on the reservation as taxable. On June 1, 1990, that section was replaced by section .0116 which states in part: “Federal taxable income must be decreased by the following deductions to the extent the amounts are included in Federal gross income...(10) Income earned by an enrolled member of the Eastern Band of Cherokee Indians or other federally recognized tribes if such income is derived from activities on the Cherokee reservation while the member resided on the reservation.”
7. An individual retirement account is a trust created for the benefit of an individual or his beneficiaries and the entire interest of the owner is nonforfeitable. Any amount distributed from an individual retirement account is includable in gross income in the manner provided under the annuity rules contained in section 72 of the Internal Revenue Code. For federal income tax purposes, the type of income earned by the trust or the source of the funds contributed to the trust bears no relationship to the treatment of distributions for income tax purposes. Funds contributed to an individual retirement account and income earned on the funds held by the trust lose their identity when paid to the trustee. The \$170,000.00 received by Taxpayer from Employer’s pension plan lost its identity as retirement income associated with activity off the reservation when Taxpayer rolled the funds into an individual retirement account. Therefore, distributions from Taxpayer’s individual retirement account of \$2,731.76, \$97,365.63, and \$71,834.00 in 1990, 1991, and 1992, respectively, are not taxable for State income tax purposes.
8. The Court of Appeals in *Wildcatt v. Smith* 69 N.C. App.1, 316 S.E.2d 870 (1984) held that “...the members of the Eastern Band of Cherokees have a dual status. They are citizens of North Carolina. Nevertheless, they are a federally recognized Indian tribe, and the land on which they earn their livelihood is a federally recognized Indian reservation held in trust for their benefit by the United States.” Pursuant to the Fourteenth Amendment to the United States Constitution, Indians as citizens of the United States, are also citizens of the state in which they reside, even though they may live on a reservation. (*Acosta v. County of San Diego*, 126 Cal App 2d 455, 272 P2d 92) They have the right to vote and are qualified to serve as jurors and are competent witnesses in judicial proceedings. “Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws are inseparable from

responsibility for sharing the costs of government. These are rights and privileges which attach to domicile within the state.” *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 312-313, 81 L. Ed. 666. (1937).

9. States have authority to tax all income of their residents, including income earned outside their borders. For individual income tax purposes, a North Carolina resident is an individual who is domiciled in this State at any time during the taxable year or who resides in this State for other than a temporary or transitory purpose. A resident is subject to State income tax on all his income, both within and outside the State. Although residing on the reservation, enrolled members are citizens and residents of North Carolina, and such members receiving income derived from sources off the reservation, including income from sources in other states, are subject to the same State tax laws otherwise applicable to all citizens and residents of North Carolina. Consequently, Taxpayer’s income from sources in other states, such as the wages and strike benefits, are subject to North Carolina income tax.
10. A penalty of 5 percent of the tax for each month, or part of a month (maximum 25 percent) the return is late is required. Because Taxpayer did not file the 1990 return, a penalty of 25 percent of the tax is properly due.
11. A penalty of 10 percent of the tax not paid when due is required. Because Taxpayer did not meet this requirement for the tax year 1990, the late payment penalty is properly due.
12. A penalty of 10 percent of the deficiency for negligent failure to comply with the income tax laws is required. The Taxpayer did not file his 1990 State income tax return. On May 26, 1998, the Department notified the Taxpayer of this and invited him to respond by June 26, 1998. The letter stated, among other things that, “Please note that interest and certain penalties apply to delinquent tax owed the State of North Carolina”. (Exhibit PT-17) The Taxpayer did not respond. On July 30, 1998, the Department sent a second request inviting a response and containing the identical above quoted warning by August 21, 1998. (Exhibit PT-18) The Taxpayer did not respond. On February 21, 1999, the Department issued the proposed assessments. (Exhibits PT-2 through PT-5) Only then did the Taxpayer respond. Taxpayer failed to exercise the degree of care considered responsible under the circumstances which constitutes negligence. Consequently, the 10 percent negligence penalty is properly due.
13. A penalty is required for underpayment of estimated income tax. The penalty does not apply if the individual did not have any income tax liability for the preceding taxable year. Because Taxpayer did not have a State income tax liability for the tax year 1989, the penalty for underpayment of estimated income tax for the taxable year 1990 is not due.
14. The Secretary of Revenue is authorized to waive or reduce any penalty. Such waiver or reduction results from the taxpayer establishing reasonable cause for waiving or reducing the penalty assessed.

DECISION

There is no evidence that Taxpayer did not file a 1990 State income tax return because he relied on former rule .1747. Taxpayer did not file a 1990 federal return until September 1994. Based on the foregoing evidence, findings of fact, and conclusions of law, the Assistant Secretary finds that the individual income tax assessment proposed against Taxpayer for the taxable year 1990 is lawful and proper and is hereby sustained subject to the following modifications:

Federal taxable income		\$45,819.00
Less: Retirement benefits exclusion	\$2,000.00	
Interest income	2,204.00	
IRA income	<u>2,732.00</u>	<u>6,936.00</u>
Total		\$38,883.00
Add: Personal exemption adjustment		<u>100.00</u>
Corrected State taxable income		\$38,983.00
Tax as corrected		\$ 2,558.00
Late filing penalty		639.50
Late payment penalty		255.80
Negligence penalty		255.80
Interest computed to August 31, 2001		<u>2,180.73</u>
TOTAL DUE		<u>\$ 5,889.83</u>

The Assistant Secretary finds that there is no additional tax due for the taxable years 1989, 1991, or 1992; therefore, the proposed assessments for those years are hereby withdrawn. The penalties for the taxable year 1990 are properly asserted and the Assistant Secretary declines to waive them.

The proposed assessment for the taxable year 1990 as heretofore modified, is hereby declared to be finally determined and immediately due and collectible, together with interest as allowed by law.

Made and entered this 30th day of July, 2001

Signature _____

Eugene J. Cella
Assistant Secretary of Revenue