

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 1999 by)
the Secretary of Revenue of North Carolina)

vs.)

[Taxpayer])

FINAL DECISION
Docket No. 2002-397

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on August 27, 2002, upon an application for hearing by [Taxpayer], wherein he protested the proposed assessment of additional income tax for the taxable year 1999. 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, an assessment proposing additional tax and accrued interest totaling \$1,607.73 for the tax year 1999 was mailed to Taxpayer on March 11, 2002. Taxpayer filed a timely protest to the proposed assessment and requested a hearing before the Secretary of Revenue.

ISSUE

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

Is the assessment for additional income tax proposed against Taxpayer for the taxable year 1999 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 attachment, copies of which are collectively designated as Exhibit PT-2.

3. Notice of Individual Income Tax Assessment for the taxable year 1999 dated March 11, 2002, a copy of which is designated as Exhibit PT-3.
4. Amended Notice of Individual Income Tax Assessment for the taxable year 1999 dated May 14, 2002, a copy of which is designated as Exhibit PT-4.
5. 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-5.
6. Letter from Taxpayer to Department of Revenue dated April 16, 2002, a copy of which is designated as Exhibit PT-6.
7. Letter from Patrick G. Penny, Administrative Officer in the Personal Taxes Division, to Taxpayer dated May 9, 2002, a copy of which is designated as Exhibit PT-7.
8. Letter from Taxpayer to Patrick G. Penny dated June 6, 2002, a copy of which is designated as Exhibit PT-8.
9. Letter from Eugene J. Cella to Taxpayer dated June 25, 2002, a copy of which is designated as Exhibit PT-9.

Taxpayer presented the following evidence at the hearing:

1. Letter from the Internal Revenue Service to [a taxpayer], a copy of which is designated as Exhibit TP-1.
2. Excerpt from 5 USC § 6381, a copy of which is designated as Exhibit TP-2.

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 individual income tax return for the tax year 1999 on April 19, 2000. The return reflected federal taxable income of zero, North Carolina income tax of zero, and North Carolina tax withheld of \$336.00. Taxpayer requested a refund of \$336.00, which was refunded to him in June 2000.
3. Upon examination, the Department of Revenue determined Taxpayer's federal taxable income for the tax year 1999 to be \$21,424.00, consisting of wages of \$27,774.00 based on information received from the Internal Revenue Service; allowed the standard deduction for married filing separately; and allowed one personal exemption. Taxpayer's North Carolina taxable income was determined to also be \$21,424.00.
4. A Notice of Individual Income Tax Assessment proposing an assessment of additional income tax and accrued interest totaling \$1,607.73 was mailed to Taxpayer on March 11, 2002. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.

5. Taxpayer understated taxable income by twenty-five percent or more of gross income for tax year 1999.
6. Subsequent to receiving the hearing request, the Department of Revenue determined that the standard deduction and personal exemption adjustments had been omitted from the calculation of Taxpayer's North Carolina taxable income. The Department recalculated Taxpayer's North Carolina taxable income to be \$22,774.00 by increasing federal taxable income by \$1,100.00 for the difference between the amount allowed for the federal standard deduction and the State standard deduction and by \$250.00 for the difference between the amount allowed for the federal personal exemption and the State personal exemption. The Department also determined that a twenty-five percent negligence penalty and a \$500.00 penalty for filing a frivolous return were also due but were not included on the original assessment notice. Taxpayer was informed of these errors in a subsequent letter dated May 9, 2002. An amended assessment notice reflecting Taxpayer's corrected North Carolina taxable income and penalties was mailed to Taxpayer on May 14, 2002. The amended notice reflected additional tax, penalties, and interest of \$2,603.54.
7. Subsequent to mailing the amended assessment notice on May 14, 2002, the Department determined that a five percent failure to file penalty is also due since Taxpayer filed the 1999 return late on April 19, 2000.
8. Taxpayer contends that (1) the Internal Revenue Code ("Code") does not impose an income tax liability nor require that income tax be paid on the basis of a return; (2) the Department of Revenue cannot propose an assessment against him prior to the conclusion of his due process hearing with the Internal Revenue Service; (3) he had no "taxable" income for the tax year 1999; (4) only people who work for the government or the District of Columbia can earn "wages" as defined in Code section 3401(a); (5) individuals cannot be taxed on compensation they receive in return for their "labor"; and (6) taxing a person's "labor" is a violation of their constitutional rights.

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 \$1,350.00 were properly made for the tax year 1999.
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 is imposed for failure to file a return when due. The penalty is equal to five percent of the tax for each month, or fraction of a month, the return is late (minimum \$5.00, maximum twenty-five percent). Because Taxpayer filed his 1999 return late on April 19, 2000, a penalty of \$74.40 is properly due for failure to file the return when due.
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 \$372.00 is due for the tax year 1999 because Taxpayer understated taxable income by twenty-five percent or more of gross income.
9. The penalty of \$500.00 for filing a frivolous return cannot be assessed against Taxpayer since the frivolous return penalty applies only to returns filed on or after October 1, 2000.
10. 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.

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, to the extent hereinafter modified, to be lawful and proper and is hereby affirmed.

Taxpayer contends that the Internal Revenue Code does not impose an income tax liability nor require that income tax 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 the 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, I find that State 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 Department of Revenue cannot propose an assessment against him prior to the conclusion of his due process hearing with the Internal Revenue Service. Taxpayer argues that he entered *zero* as his federal taxable income on his State return because his federal return reflected federal taxable income of *zero*. Taxpayer further argues that until the Internal Revenue Service issues a final determination showing that his federal taxable income is something different than *zero*, the State must use *zero* as his federal taxable income. I find no provision in the law which precludes the Department of Revenue from determining a taxpayer's correct North Carolina tax liability and proposing assessments reflecting the correct tax liability prior to the conclusion of an Internal Revenue Service due process hearing. Furthermore, G.S. 105-134.5 defines North Carolina taxable income as the taxpayer's taxable income as determined under the Internal Revenue Code, adjusted as

provided in G.S. 105-134.6 and G.S. 105-134.7. "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 information other than that provided on a taxpayer's federal return to determine what taxes are actually owed to the State.

Taxpayer contends that he had no "taxable" income during the tax year 1999. Taxpayer argues that he does not earn wages as defined in Code section 3401(a) because he is not an "employee" as defined in Code section 3401(c). Taxpayer argues that the only "employees" that are subject to income taxes on wages are people who work for the government or the District of Columbia. These arguments are based on an apparent misinterpretation of section 3401 of the Internal Revenue Code, which imposes responsibilities to withhold tax from "wages." That section establishes the general rule that "wages" include all remuneration for services performed by an employee for his employer. Code section 3401(c) states that "for purposes of this chapter, the term 'employee' includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing." Code 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 and state employees and officials a part of the definition of "employee," which generally includes private citizens.

Taxpayer contends that individuals cannot be taxed on compensation they receive in return for their "labor." Taxpayer argues that employers are responsible for the payment of any

taxes due on profits derived from "labor" used in their business, trade, profession, or occupation; however, the individual workers do not recognize a profit from providing their labor and, therefore, are not subject to income tax. I find that wages and salaries are includible in an individual's gross income. Taxpayer earned wages of \$27,774.00 during 1999 that must be included in Taxpayer's gross income for that taxable year. Taxpayer is responsible for the payment of any resulting income tax due on the wages.

Taxpayer argues that the North Carolina Constitution grants him the right to life, liberty, and the fruits of his labor. Therefore, to assess a tax on labor would be a violation of Taxpayer's constitutional rights. I find that 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.

Taxpayer presents many arguments in defense of his position that the assessment is 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. Therefore, the proposed assessment for the tax year 1999, modified to exclude the frivolous return penalty; to include the standard deduction and personal exemption adjustments; to include a twenty-five percent negligence penalty of \$372.00; and to include a failure to file penalty of \$74.40, is hereby sustained in its entirety and is determined to be finally due and collectible.

Made and entered this 8th day of October, 2002.

Signature _____

Eugene J. Cella

Assistant Secretary for Administrative Tax Hearings
North Carolina Department of Revenue