

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)
1998 and 1999 by the)
Secretary of Revenue of North Carolina)
vs.)
[Taxpayers])

FINAL DECISION
Docket No. 2001-69

This matter was heard before the Assistant Secretary for Administrative Tax Hearings, Eugene J. Cella, in the city of Raleigh on August 2, 2001, upon an application for hearing by [Taxpayers, Husband and Wife], wherein they protested the proposed assessments of additional income tax for the taxable years 1998 and 1999. The hearing was held under the provisions of G.S. 105-260.1 and was attended by Taxpayers; Nancy R. Pomeranz, Director of the Personal Taxes Division; and [a person] who recorded the proceedings at Taxpayers' request.

Husband and Wife filed separate North Carolina individual income tax returns for the taxable year 1998 reflecting federal taxable incomes of zero. Taxpayers filed a joint 1999 return reflecting federal taxable income of zero. Upon examination, the Department determined that Taxpayers were excluding their wages from federal taxable income. Notices of Individual Income Tax Assessment proposing additional tax, a twenty-five percent negligence penalty, and accrued interest for the tax years 1998 and 1999 were mailed to Taxpayers on June 11, 2000. Taxpayers 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 Husband and Wife for the tax year 1998 and against Taxpayers for the tax 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. Husband's North Carolina individual income tax return for the taxable year 1998, a copy of which is designated as Exhibit PT-2.
3. Wife's North Carolina individual income tax return for the taxable year 1998, a copy of which is designated as Exhibit PT-3.
4. Taxpayers' North Carolina individual income tax return for the taxable year 1999, a copy of which is designated as Exhibit PT-4.
5. Notice of Individual Income Tax Assessment for the taxable year 1998 dated June 11, 2000, to Husband, a copy of which is designated as Exhibit PT-5.
6. Notice of Individual Income Tax Assessment for the taxable year 1998 dated June 11, 2000, to Wife, a copy of which is designated as Exhibit PT-6.
7. Notice of Individual Income Tax Assessment for the taxable year 1999 dated June 11, 2000, to Taxpayers, a copy of which is designated as Exhibit PT-7.
8. North Carolina Administrative Code, Title 17, subchapter 6B, rule .0101, a copy of which is designated as Exhibit PT-8.
9. Letter from Taxpayers to the Department of Revenue dated July 5, 2000, a copy of which is designated as Exhibit PT-9.
10. Letter from S. P. Hartigan, Tax Auditor in the Office Examinations Division, to Taxpayers dated September 7, 2000, a copy of which is designated as Exhibit PT-10.
11. Letter from Taxpayers to S. P. Hartigan dated September 29, 2000, a copy of which is designated as Exhibit PT-11.
12. Letter from Gregory B. Radford, Assistant Director of the Personal Taxes Division, to Taxpayers dated October 23, 2000, a copy of which is designated as Exhibit PT-12.
13. Letter with related attachments from Taxpayers to Gregory B. Radford dated November 21, 2000, copies of which are designated as Exhibit PT-13.
14. Letter from Michael A. Hannah, former Assistant Secretary of Revenue, to Taxpayers dated December 4, 2000, a copy of which is designated as Exhibit PT-14.
15. Letter from Michael A. Hannah to Taxpayers dated December 29, 2000, a copy of which is designated as Exhibit PT-15.

16. Letter from Marilyn R. Mudge, former Acting Assistant Secretary of Revenue, to Taxpayers dated April 9, 2001, a copy of which is designated as Exhibit PT-16.
17. Letter from Husband to Marilyn R. Mudge dated April 25, 2001, a copy of which is designated as Exhibit PT-17.
18. Letter from Marilyn R. Mudge to Taxpayers dated May 9, 2001, a copy of which is designated as Exhibit PT-18.
19. Letter from Gregory B. Radford to Taxpayers dated May 21, 2001, a copy of which is designated as Exhibit PT-19.
20. Letter from Eugene J. Cella to Taxpayers dated May 21, 2001, a copy of which is designated as Exhibit PT-20.

At the hearing, Taxpayers presented an affidavit entitled "Responses to Brief for Tax Hearing," a copy of which is 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 the tax years 1998 and 1999.
3. Each return reflected federal taxable income of zero and additions to federal taxable income equal to the amount by which the standard deduction and personal exemption claimed on the federal return had been increased for inflation. Husband's 1998 return reflected North Carolina tax withheld of \$2,424.00 and an overpayment of \$2,348.00. Wife's 1998 return reflected North Carolina tax withheld of \$1,557.00 and an overpayment of \$1,481.00. The 1998 overpayments were refunded to the Taxpayers. Taxpayers' 1999 return reflected North Carolina tax withheld of \$3,413.00 and an overpayment of \$3,252.00. The 1999 overpayment was not refunded to Taxpayers.
4. Upon examination, the Department calculated Husband's 1998 federal taxable income to be \$35,701.00 and Wife's federal taxable income to be \$21,986.00 by subtracting the standard deduction for a married individual filing separately and one personal exemption from total wages as reported by Taxpayers' employers. The Department calculated North Carolina taxable income to be \$36,951.00 for Husband and \$23,236.00 for Wife by increasing federal taxable income for the difference in the State and federal standard deduction and personal exemption. For taxable year 1999, the Department calculated Taxpayers' federal taxable income to be \$56,296.00 by subtracting the standard deduction for a married couple filing jointly and two personal exemptions from total wages. The Department calculated North Carolina taxable income to be \$58,996.00 by

increasing federal taxable income for the difference in the State and federal standard deduction and personal exemption.

5. Included with their respective 1998 returns were wage and tax statements for Husband from [Husband's employer] and for Wife from [Wife's employer] showing wages of \$41,951.44 and \$28,235.62, respectively. Included with the jointly filed 1999 return were wage and tax statements from [Husband's employer] and [Wife's employer] showing Husband's wages of \$49,201.49 and Wife's wages of \$19,794.93, respectively.
6. Pursuant to G.S. 105-241.1, Notices of Individual Income Tax Assessment proposing assessments of additional income tax, a twenty-five percent negligence penalty, and accrued interest for the tax years 1998 and 1999 were mailed to Taxpayers on June 11, 2000.
7. Taxpayers objected to the proposed assessments and timely requested a hearing before the Secretary of Revenue.

CONCLUSIONS OF LAW

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

1. It is the duty of the North Carolina Department of Revenue to collect taxes due to the State.
2. 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.
3. "Taxpayer" is defined as an individual subject to the individual income tax. "Individual" is defined as a human being.
4. 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.
5. 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.
6. 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 \$1,250.00 on the separate returns of Husband and Wife were properly made for the tax year 1998. An addition of \$2,700.00 was properly made to the joint return for tax year 1999.

7. An individual is required to file a federal income tax return if 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 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 Secretary of Revenue may require a taxpayer to verify any information on the taxpayer's individual income tax return. An income tax return shall be filed as prescribed by the Secretary. Form D-400 and Form D-400EZ are the forms prescribed by the Department of Revenue as the proper forms for individual income taxpayers to file.
9. If the taxpayer does not provide adequate and reliable information upon which to compute the 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.
10. 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.
11. If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer is required to file a return with the Secretary of Revenue reflecting the corrected or determined taxable income.
12. A twenty-five percent negligence penalty is imposed for large individual income tax deficiencies. 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. Twenty-five percent negligence penalties were properly assessed for the tax year 1998 because Husband understated taxable income by eighty-five percent of gross income and Wife understated taxable income by seventy-eight percent of gross income. Taxpayers understated 1999 taxable income by eighty-two percent of gross income.
13. The Secretary of Revenue's duties includes 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.
14. Wages and other forms of compensation provided for services constitute taxable income.

15. The proposed assessments are lawful and proper based on the best information available and should be sustained in their entireties.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary of Administrative Hearings finds the proposed assessments for the tax years 1998 and 1999 to be lawful and proper and they are hereby affirmed.

Taxpayers have offered no defense directly addressing the calculation of the proposed liabilities. However, they do offer the following arguments: (1) they earned no income; (2) compensation for services is not income and is excludable from taxation; (3) no statute authorizes the Internal Revenue Service or the North Carolina Department of Revenue to change their returns; (4) the Secretary of Revenue is the only individual that has the statutory authority to make a proposed assessment of North Carolina income tax; and (5) North Carolina has unconstitutionally delegated its legislative power by relying on federal laws and regulations instead of incorporating those laws into North Carolina's statutes.

Taxpayers contend that they do not have income because the Internal Revenue Code does not define "income" and that 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. 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 *U.S. v. Ballard* does not support Taxpayers' position that they have no North

Carolina income tax liability. In *Ballard*, the court recited the Code's definition of "gross income," which includes compensation for services, including fees, commissions, and similar items (26 U.S.C. 61). *Ballard* was concerned primarily with income from a merchandising business and whether gross income was the gross receipts from the business or the gross receipts less expenses. The taxpayers 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.

Taxpayers contend that income is limited to corporate profit and cite *Merchant's Loan and Trust Co. v. Smietanka*, 255 U.S. 509, *Doyle v. Mitchell Brothers*, 247 U.S. 179, *Stratton's Independence v. Howbert*, 231 U. S. 399, and *Southern Pacific v. Lowe*, 247 U. S. 330, in support of their position. None of the cases support their arguments. In *Eisner v. Macomber*, 252 U. S. 189, the court defined income as "the gain derived from capital, from labor, or from both combined..." In *Glenshaw Glass Co.*, S. Ct., 348 U.S. 426, 55-1 USTC ¶9308, the court concluded that 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 Loan and Trust Co.*, 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's 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 *E. M. Lonsdale*, CA-10, 90-2 USTC ¶50,581, *H.H. McKinley*, DC Ohio, 92-2 USTC ¶50,509, *A. Ficalora*, CA-2, 85-1 USTC ¶ 9103, *C. Stelly*, CA-5, 85-2 USTC ¶9436, *Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68 (7th Cir. 1986.) Taxpayers can cite no case that rules otherwise.

Taxpayers contend that no section of the Internal Revenue Code imposes an income tax 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 or requires a return to be filed; those issues are between Taxpayers 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, the relevant provision is G.S. 105-134 which 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 a taxpayer and requires the taxpayer to file a State income tax return.

Taxpayers contend that no section of the Internal Revenue Code gives anyone the authority to change their return and the Internal Revenue Service has not perfected its assessment against them. Again, 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 Service has authority to adjust a taxpayer's federal income tax return; that issue is between Taxpayer and the Internal Revenue Service. However, I note that Chapter 63 of the Internal Revenue Code addresses assessments and deficiencies. It is clear from my reading of that section of the Code that the Internal Revenue Service is authorized to determine if the return filed by a taxpayer is correct and to assess any deficiency resulting from the taxpayers' errors.

Taxpayers also contend that the proposed assessments are void because the Secretary of Revenue did not individually propose the assessments or specifically, in writing, delegate the authority to issue the proposed assessments to an employee of the Department. Taxpayers' position is simply not reasonable. The Secretary of Revenue, as head of the Department of Revenue, cannot individually propose assessments and that is certainly not the intent of the law. Assessments of tax must be "of the Secretary," meaning that the assessments may only be proposed by the Department of Revenue.

The law does not require the Secretary to issue a delegation of authority in writing to each of the Department's employees to perform the duties of their job. G.S. 105-258 empowers the Secretary to appoint agents to determine liabilities of all persons for any tax imposed under The Revenue Act. The authority of an employee of the Department of Revenue to perform the duties of his or her position is implicit and arises automatically from the individual's appointment by the Secretary to that position. Notices of assessment are routinely issued by the Department's employees in the normal course of business activity.

Finally, Taxpayers contend that North Carolina 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 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 Internal Revenue Code would likely be held to be an unconstitutional delegation of legislative power. Taxpayers' 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 Internal Revenue 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 selects a reference date the same as or prior to the date State legislation is enacted to insure that it is not delegating its power to tax to the United States Congress in violation of the North Carolina Constitution.

The arguments raised by taxpayers are generally constitutional in nature and relate to the question of whether they can be held liable for an income tax. These familiar arguments have been made on many occasions both before the courts and in previous administrative tax hearings by taxpayers that object to the payment of income tax. I find all of Taxpayer's arguments to be without merit. Therefore, the proposed assessments for the tax years 1998 and 1999 are hereby sustained in their entireties and are determined to be final and collectible, together with interest as allowed by law.

Made and entered this 6th day of December, 2001.

Signature_____

Eugene J. Cella
Assistant Secretary for Administrative Tax Hearings