TAXABLE INCOME

(The Evolution of a Deception)

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Introduction

For centuries the phrase "paying your taxes" has been used to express a citizen's duty to his country. But while most feel an obligation to pay their taxes, very few feel qualified to figure out just what their taxes are. So instead they hire tax professionals, whose determinations seem to be one part accounting and two parts witchcraft. An astounding amount of money is spent every year, not just on the actual taxes, but on paying tax experts to delve into the treacherous jungle of the federal tax code and come out with a solid number representing the client's tax liability.

It's no secret, however, that different tax-law witch doctors will end up with different bottom lines, based upon the *same* set of financial facts—strengthening even more the impression that deciphering the tax laws is more like astrology than mathematics. In fact, it is all but universally conceded now, including by top government officials, that the tax code is indecipherable, and that no one truly understands it all, or has even read it all. None other than Albert Einstein is quoted as saying, "The hardest thing in the world to understand is the income tax." Nonetheless, tens of millions of us are expected to comply with it every year, even though no one knows for sure what all it requires.

As it turns out, however, the United States federal tax code contains something far more sinister than its outrageous complexity. And though this "something" is admittedly complex, with a little effort it can be known and understood, even by those of us unaccustomed to dealing with the legalese voodoo of the tax code. (Ironically, it is those arrogant enough to believe that they already understand everything about the tax laws who seem to be the least able to understand and accept the incriminating evidence found in the labyrinth of law books.)

The evidence to be found by those who dare to look does not reveal mere complexity, contradiction, and unfairness in the tax code—none of which would be likely to surprise anyone—but instead shows something far more disturbing and more devious: not a mistake or a loophole, but a premeditated, prolonged, concerted effort to deceive and defraud the American public, to the tune of well over one *trillion* dollars ($1,000,000,000,000) every year.

Some dismiss out of hand anything they view as a "conspiracy theory," and the larger the alleged conspiracy, the less likely they are to believe it. A multitrillion-dollar deception will, therefore, be rejected out of hand as ridiculous by many people, regardless of the evidence. Albert Einstein also said that the highest form of arrogance is "condemnation before investigation." For those who dare to follow the evidence wherever it leads, the facts can speak for themselves. What follows is evidence of the largest financial fraud in history, perpetrated by agents of the United States government.

A New Kind of Country

After the American Revolution, in which the American colonies won their independence from England, there was vigorous debate over the form of government that should be installed. The "federalists" won out, and the result was the Constitution for the United States of America.

The essence of the plan was quite simple: the governments of the individual states (formerly colonies) would retain their power, and each would, for the most part, continue as a sovereign entity. At the same time, there would be a union among the states, and a "federal" government which would handle certain specific matters concerning the several states. Issues such as postal routes, military-related matters, regulating commerce crossing state and country borders, and a few others, were thought to be better handled centrally, rather than each state handling such things in different ways. However, it was also agreed that the powers delegated to the federal government were to be strictly limited to specific tasks, and that all other powers would still belong to the people and the state governments. James Madison, the so-called "Father of the Constitution," summed this up quite well:

"The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite." [James Madison, Federalist #45]

In fact, the Ninth and Tenth Amendments to the Constitution (part of the Bill of Rights) were written specifically to make it clear that the federal government was not to do anything other than what the Constitution specifically empowered it to do.

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." [Tenth Amendment, U.S. Constitution]

The Power to Tax

Article I, Section 8 of the Constitution lists the powers that the federal government is authorized to exercise within the states. The list begins by saying that Congress was to have the power "*to lay and collect taxes*," which of course was needed to provide the funding necessary for the federal government to carry out its other duties. It was not long, however, before disputes arose about the extent of the taxing powers of the state and federal governments. Some argued that "the power to tax is the power to destroy," thereby concluding that if a government was not at liberty to regulate or forbid something, it also should not be allowed to *tax* it.

"[N]*o state has the right to lay a tax on interstate commerce in any form* [because] *such taxation is a burden on that commerce, and amounts to a regulation of it, which belongs solely to congress. This is the result of so many recent cases that citation is hardly necessary."* [Leloup v. Port of Mobile, 127 U.S. 640 (1888)]

This raises the question: If Congress can regulate only certain matters inside the states, might it be able to *tax* only these matters as well? The U.S. Constitution does not spell out exactly *what* Congress can tax, but provides two sets of rules for two basic types of taxes, into which all federal taxes can be categorized: "direct" taxes and "indirect" taxes.

Direct Taxes: So-called "direct" taxes included per capita taxes and property taxes, and under the Constitution all such "direct" taxes are required to be divided up ("apportioned") among the different states in proportion to the population of each state. (So, for example, if Pennsylvania had twice the population of North Carolina, it would pay twice as big a portion of the overall national tax.) Such "direct" taxes have been used only a very few times by the federal government, and never in the last century.

Indirect Taxes: The other category of taxes, called "indirect" taxes, includes import/export taxes as well as "excise" taxes. The Supreme Court sums up what belongs in this category: "*customs and excise duties imposed on importation, consumption, manufacture, and sale of certain commodities, privileges, particular business transactions, vocations, occupations, and the like.*"[1]* Instead of being apportioned, "indirect" taxes need only be geographically uniform, meaning they are applied the same throughout the entire country. Numerous "excise" taxes have been imposed by the federal government over the years, on everything from oleomargarine to wagering, and from distilling whiskey to manufacturing machine guns. In fact, *all* current federal taxes are "indirect" taxes.

Where Does an Income Tax Fit?

At this point an astute observer might notice that a general, all-inclusive income tax does not fit well within either category: it is not a tax on property ownership *per se*, nor is it a tax on certain commodities or activities. So where does such a tax fit in the Constitutional design?

The first federal income taxes were imposed in the 1860s, and it was not long before the "direct" versus "indirect" question made it to the Supreme Court. This eventually led to the ruling in Pollock v. Farmers Loan & Trust, (157 U.S. 429 (1895)), in which the Supreme Court threw out the federal income tax as being unconstitutional. The court concluded that a tax on income which comes from owning property (e.g., interest and dividends) is in essence a tax on the property itself, which would belong in the category of "direct" taxes. And because the income tax was not apportioned, as all direct taxes must be, it was deemed invalid. (Of note, the Court explained that its reasoning would not apply to income from things *other* than property ownership, such as wages, but it still threw out the entire tax, saying it was not at liberty to divide a law into pieces and then throw out only some of them.)

Unfortunately, the conclusive answer to the "direct" versus "indirect" debate, which came in the form of the 16th Amendment (in 1913), caused more confusion than clarity. That amendment reads as follows:

"*The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*" [16th Amendment, U.S. Constitution]

The wording of that amendment quickly convinced a lot of people of two things:

1) Though the income tax is a "direct" tax, it does not need to be apportioned.
2) Congress had acquired the power to tax any income it wanted to.

[l] Flint v. Stone Tracy, 220 U.S. 107 (1911)
* All underline emphasis in this report has been added

While both of those conclusions are somewhat understandable based upon the wording of the amendment, both also happen to be *dead wrong*: the amendment did *not* authorize an unapportioned "direct" tax, and it did *not* allow Congress to tax all income from anywhere.

The Supreme Court, on more than one occasion, has made it abundantly clear that the 16th Amendment, rather than authorizing an unapportioned "direct" tax, merely confirmed once and for all that the federal income tax "*inherently belongs*" in the category of "indirect" taxes, which must apply uniformly throughout the country, but which do not need to be apportioned[2]. In reality, therefore, the 16th was more of a clarification than an amendment, as it did not actually alter Congress' taxing powers.

Limits on the Taxing Power

Far more significant than the misunderstanding about academic issues related to "direct" and "indirect" taxes is the false impression which the 16th Amendment created that, after the amendment was enacted, there were no longer any limits upon what Congress could tax, and that Congress could then tax all income, coming from anywhere and received by anybody, as the "*from whatever source derived*" language implies.

Once again, the Supreme Court made it clear that this is not the case. The Court has clearly ruled that the 16th Amendment "*conferred no new power of taxation*" upon Congress[2] (which the Secretary of the Treasury officially agreed with in Treasury Decision 2303), in addition to ruling that the amendment "*does not extend the taxing power to new or excepted subjects*"[3], that it did not "*render anything taxable as income that was not so taxable before*"[4], and in fact that the words "*from whatever source derived*" used in the amendment were not intended to have <u>any effect</u> "*on which incomes were subject to federal taxation*"[5].

(Interestingly, in a dissenting opinion regarding another issue entirely, one Supreme Court justice explained the point that "*a literal reading of a provision of the Constitution which defeats a purpose evident when the instrument is read as a whole, is not to be favored*," and gave several examples, including this: "'*From whatever source derived,' as it is written in the Sixteenth Amendment, <u>does not mean from whatever source derived</u>*"[6]. Clearly he was acknowledging that the very broad, apparently all-encompassing terminology of the 16th Amendment is, when taken by itself, misleading.)

Despite all of those clear and unequivocal statements by the Supreme Court, numerous lower court judges and other supposed legal experts continue to parrot the popular myth that the 16th Amendment *did* increase or expand Congress' taxing power, when it did no such thing.

[2] Stanton v. Baltic Mining, 240 U.S. 103 (1916)
[3] Peck v. Lowe, 247 U.S. 165 (1918)
[4] Evans v. Gore, 253 U.S. 245 (1920)
[5] South Carolina v. Baker, 485 U.S. 505 (1988)
[6] Wright v. United States, 302 U.S. 583 (1938) (dissenting opinion)

Tax Imposed

Since the federal income tax was brought back in 1913, shortly after the 16th Amendment was enacted, the federal tax statutes have imposed a tax upon the taxable income of every individual (though the older laws used the term "net income" instead), which is determined by subtracting allowable deductions from one's "gross income." The term "gross income" (in the last 80+ years of statutes) is defined in turn to mean just about every type of income imaginable. For example, Section 61 of the current tax code defines "gross income" to mean "*all income from whatever source derived*," including items such as compensation for services, interest, rents, business income, and so on. While the exact wording of the definition has varied over the years, the apparently all-encompassing scope of the term has not. In fact, the Supreme Court has stated that the very broad wording of the definition of "gross income" used in the statutes was intended by Congress to exert "*the full measure of its taxing power*"[7]. Put another way, the legislature used such sweeping language in order to tax everything it had the power to tax.

But what exactly *is* the "full extent" of Congress' taxing power? Are there any limits to what the federal government can tax? If so, how can that be reconciled with the apparently unlimited, all-inclusive definition of the term "gross income" (which, after subtracting deductions, becomes "taxable income")?

"*It is elementary law that every statute is to be read in the light of the Constitution. However broad and general its language it cannot be interpreted as extending beyond those matters which it was within the constitutional power of the legislature to reach.*" [McCullough v. Virginia, 172 U.S. 102 (1898)]

Under the above-stated principle (which the Supreme Court called "elementary law"), Congress can enact very broadly worded statutes, but they still must be read and understood with the Constitutional limits in mind. In the above-cited case, the Court went on to say that the general language of a particular taxing statute was "*not to be read as reaching to matters in respect to which the legislature had no constitutional power*," but instead, if the broad wording would seem to cover matters beyond the control of the legislature, "*the statute is to be read as though it in terms excluded them from its operation*." Put into more modern vernacular, that simply means that every law must be read as though it specifically exempts any matters which are beyond the constitutional power of whichever government enacted the law.

This is a crucial point to understand: CPAs, attorneys and IRS agents—even federal judges—*do not know* that such a principle of law even exists, and so *do not take it into account* when determining the correct application of the federal income tax. Instead, they accept the broadly-worded definitions at face value, unaware that Constitutional limits might apply to that law.

[7] Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955)

But the question remains: *Are* there any limits on what Congress can tax, and if so, what are they? If, as the Supreme Court says, every statute must be interpreted in light of the Constitution, how is the average citizen to know whether or not there are any such limits on an otherwise broadly-worded law, and how is he to determine what those limits are? Every citizen cannot be expected to be a Constitutional scholar, nor should individuals have to *guess* at what Constitutional limits might apply to any given law. So whose "interpretation" of the law is a citizen to rely upon?

The laws passed by Congress are coded into the "statutes" of the United States Code, but it is the "Executive" branch of the government—not the Legislative (Congress)—which administers and enforces federal laws. To do this, federal agencies write "regulations" which set down their official interpretation of Congress' laws. (The statutes themselves authorize this process, such as Section 7805 of the tax code, which gives the Secretary of the Treasury the authority to write regulations for the interpretation and administration of the federal tax code.) Not only are Executive Branch agency regulations legally binding on all federal agents and employees, but when published in the Federal Register, those same regulations also constitute the *official notice* to members of the general public regarding what is legally required of them.

Occasionally a regulation is challenged in court as being an improper interpretation or implementation of Congress' statutes. But unless a regulation is ruled to be a clearly unreasonable interpretation of a statute, even the Supreme Court must defer to what the regulations say.

"[W]*e do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner* [of the IRS], *<u>not to the courts</u>, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 USC § 7805(a)*." [United States v. Correll, 389 U.S. 299 (1967)]

So, with the legal significance of regulations in mind, let's look at some of the things the income tax regulations have said over the years. From 1913 until 1954, the income tax statutes imposed a tax on the "net income" of every individual, determined by subtracting certain deductions from his "gross income." And the statutory definition of "gross income" (as mentioned before) was so broadly worded that it would seem to cover just about every type of income imaginable. The <u>regulations</u> interpreting those statutes, however, made some very interesting admissions. In defining "net income," the older regulations stated that "*neither income exempted by statute <u>or fundamental law</u>*" are to be included in the calculation of one's "net income"[8]. (The term "fundamental law" refers to the Constitution itself.)

That regulation was simply doing what the Supreme Court (in the McCullough case, above) said should be done: interpreting a broadly-worded statute in light of the Constitution. And that regulation showed that there are indeed Constitutional limits on Congress' taxing power, even if that flies in the face of many decades of so-called conventional wisdom about the tax.

[8] 26 CFR § 39.21-1 (1956), see Appendix A

That same section of regulations went on to give a very broad definition of "income" (any gain derived from labor or property, or from both), and then explained that "gross income" means all income, except for income "*which is by statutory provision or otherwise exempt from the tax*." Then the regulations got even more specific, explaining that some types of income are specifically exempted by the tax code, and adding that "*no other items are exempt from gross income*" *except* for those types of income which are, "*under the Constitution, not taxable by the Federal Government*"[9].

The point could hardly be made more clearly than that, nor could it more clearly contradict what the vast majority of tax professionals now believe: that *all* income is taxable unless specifically exempted by statute. While at this point we have not examined anything in the law books indicating just what the Constitutional limits might be, we have clearly been told that there *are* Constitutional limits on which income is subject to the income tax—a fact to which current tax professionals are completely oblivious. (Note that the regulations quoted above were written *after* the 16th Amendment was in place, proving again that that amendment did *not* render all income taxable.) Because the above are quotes from older regulations, however, it is important to determine whether those Constitutional limits still apply today.

Cover-up #1: Hiding the Constitutional Limits

For *forty years* (1916 through 1956) the federal income tax regulations generally defining "gross income" and "net income" made specific reference to the fact that the Constitution itself limits what types of income are subject to the tax. (The 1922 regulations explicitly added that "*Such tax-free income should not be included in the return of income and need not be mentioned in the return*"[10].) However, the *current* regulations generally defining "gross income" and "taxable income" now make no reference at all to the Constitution. What happened?

No Constitutional amendments affecting the taxing power have occurred since 1913, nor has there been any significant change in the overall scope of the income tax. Therefore, whatever Constitutional limits existed *prior* to 1956 also must have existed *after* 1956 as well. So why did the wording of the regulations change at that time, removing any mention of such limits? The answer to that question provides the first example of intentional deception committed by the regulation-writers. Rather than removing the literal truth from the law books entirely, the evidence of the Constitutional limits on the taxing power was simply relocated and complicated.

Consider the following:

1) The pre-1956 regulations generally defined "gross income" to mean all kinds of income, "*derived from any source whatever, unless exempt from tax by law*"[11]. Similarly, the current regs define the same term to mean "*all income from whatever source derived, unless excluded by law*"[12]. However, while the pre-1956 regulations went on to say that income could be "exempt from tax" by statute or by the Constitution itself (aka "fundamental law"), the current regs defining "gross income" make no such admission—they do not specify exactly which "law" can exclude income from taxation.

[9] 26 CFR § 39.22(b)-1 (1956), see Appendix A
[10] Article 71, Treasury Decision 3640
[11] 26 CFR § 39.22(a)-1 (1956), see Appendix A
[12] 26 CFR § 1.61-1

Would not an honest regulation-writer want the reader to know, right up front, what income the tax does and does not apply to? And would he not want the reader to know whether some of his income might be exempt—whether it might be a *mistake* to report it as taxable?

2) In a separate, fairly obscure section of the current regulations—*not* those generally defining "gross income"—it is admitted that income can be exempted from taxation, either by "*any provision of Subtitle A*" (the income tax code), <u>or</u> by "*the provisions of <u>any other law</u>*"[13]. But while that statement shows that some "law" other than the tax code itself exempts some income, it still does not specify *which* "other law" (i.e., the Constitution) makes some income tax-exempt.

3) However, in yet another, even more obscure current regulation, it <u>is</u> still admitted that income can fall into three distinct categories: "*all income exempted by statute*," income which is "*not taxable by the Federal Government under the Constitution*," and income which is "*includible in gross income under section 61*" (the section which generally defines "gross income")[14].

4) Note that the above examples of the regs mentioning limits upon what constitutes "gross income" come not from the regulations under Section 61 of the tax code (which generally defines "gross income") but from far less frequently referenced sections—even though the second example specifically *mentions* Section 61. The same thing occurs again elsewhere.

An incredibly lengthy and convoluted section of regulations located many *hundreds* of pages away from the general definition of "gross income" says that the "items" of income listed in Section 61 of the statutes (i.e., compensation, interest, rents, business income, etc.) make up "classes of gross income," which in some cases "*may include <u>excluded</u> income*"[15]. Again, would not an honest regulation-writer make such a statement right in the regulations under Section 61 itself, instead of *hundreds* of pages away? Furthermore, if his goal were to explain the law clearly, would he not want to use less twisted, confusing language to express the point? (To say that the "classes of gross income" consisting of the items listed in Section 61 "*may include excluded income*" simply means that those items are not always subject to the tax, but are in some cases exempt, or "excluded.")

The evidence shows that the Constitutional limits still apply to the federal income tax, unbeknownst to modern tax preparers—whose ignorance is hardly surprising considering the devious changes made to the wording and arrangement of the regulations after 1956. It is also important to emphasize here that today's so-called tax experts do *not* have an alternative explanation for the evidence shown above. On the contrary, they are completely unaware that any such Constitutional limits on the taxability of income even exist, and so have no explanation at all. What the law books actually *show* and what modern tax professionals *assume* simply do not match, as illustrated in the following chart.

[13] 26 CFR § 1.265-1
[14] 26 CFR § 1.312-6
[15] 26 CFR § 1.861-8, subsections (a)(3) and (b)(1)

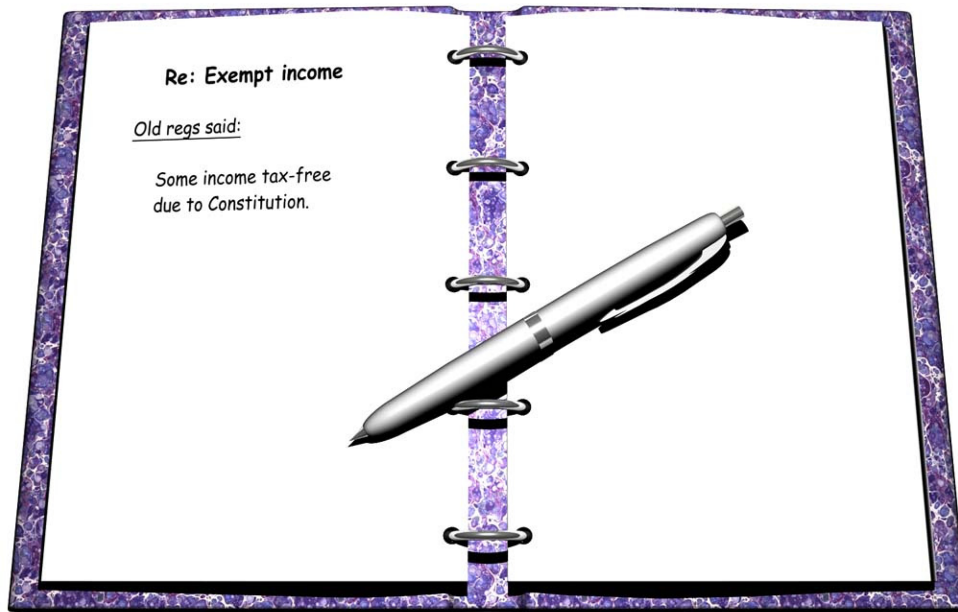
Exempt and Taxable Income

	According to Tax Professionals	*According to 90 Years of Regulations*
EXEMPT (not taxable)	Income exempted by statute*	Income exempted by statute* **Income excluded because of the Constitution itself**
TAXABLE	All other income	All other income

(*This would include things such as gifts, life insurance proceeds, and municipal bonds.)

Of course, without knowing what income is *exempt* from tax, one cannot know what income is *taxable*.

Before delving any deeper into the issue, we should start making note of the more significant clues we find along the way, so we can keep track of what we've discovered and keep the big picture in mind while navigating through all the legalese. And the foregoing is definitely a noteworthy finding: that, unbeknownst to the tax professionals, some income is tax-exempt because of the Constitution itself.



Constitutional Theory and Written Law

The obvious question at this point is: *What* income is tax-free (exempt) because of the Constitution itself? That question, however, can be approached from two different angles: by considering what an income tax *could* be applied to without violating the Constitution, and by determining what the law itself shows *is* subject to the tax. The former is more theoretical, the latter more practical. Though in this case both approaches lead to the same answer, it should be emphasized that ultimately what matters (in a practical sense) is what the law shows to be taxable, while the academic exercise of understanding *why* the law says what it says is secondary. It is addressed now only to give a complete understanding of the issue. Put another way, a citizen does not need to know *why* his income is or is not taxable, only *whether* it is taxable or not. The former is a matter of Constitutional theorizing, while the latter is determined exclusively by what the written law says. In this case, however, starting with a little theorizing will go a long way toward explaining why the law says what it says.

Virtual Limitations

As mentioned before, the Constitution prescribes rules for how "direct" and "indirect" taxes must be applied (using either apportionment or uniformity). However, the only specific statement in the Constitution limiting *what* Congress can tax is the prohibition on taxing state exports[16]. Because of this, there is a popular misconception, even among attorneys that (aside from state exports) Congress can tax anything it pleases, in any way it pleases. But that is not the case.

The Supreme Court has stated that there are "*certain virtual limitations*" on Congress' taxing power, arising from the principles of the Constitution itself, and that "*resort*[ing] *to the taxing power to effectuate an end which is not legitimate, not within the scope of the Constitution, is obviously inadmissible*"[17]. On several occasions the Supreme Court has thrown out federal tax laws as unconstitutional, on the grounds that those laws amounted to attempts to control matters not under federal jurisdiction, under the guise of imposing a "tax." For example, when Congress tried to combat "child labor" in the states (which is *not* a federal issue under the Constitution) by trying to *tax* child labor out of existence, the Supreme Court threw out the tax, and gave the following reason:

"***Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the 10th Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a socalled tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.***" [Child Labor Tax Cases, 259 U.S. 20 (1922)]

By throwing out such laws, the Court has stopped attempts at extra-Constitutional control and regulation (disguised as "taxes"), saying that such legislation "*cannot be sustained as an exercise of the taxing power of Congress conferred by Section 8, article 1*" of the Constitution[18]. But how might this principle apply, if at all, to a federal income tax?

[16] U.S. Constitution; Article I, Section 9, Clause 5
[17] United States v. Butler, 297 U.S. 1 (1936)
[18] Hill v. Wallace, 259 U.S. 44 (1922)

In one of the first rulings pertaining to the 1913 income tax, the Supreme Court gave a hint about this. After explaining that an income tax need not be apportioned, regardless of the "source" of the income (because all income taxes are "indirect" taxes), the court added this:

> "*Mark, of course, in saying this we are not here considering a tax not within the provisions of the 16th Amendment, that is, one in which the regulation of apportionment or the rule of uniformity is wholly negligible because the tax is one entirely beyond the scope of the taxing power of Congress, and where consequently no authority to impose a burden, either direct or indirect, exists.*" [Stanton v. Baltic Mining, 240 U.S. 103 (1916)]

So, not withstanding the 16th Amendment, there are still some things that Congress cannot tax at all (cannot put any "burden" upon) because such matters are outside of federal jurisdiction. (That particular ruling did not go on to spell out exactly what the jurisdictional boundaries are.)

Federal Jurisdiction

The term "jurisdiction" refers to the places or activities over which a government (or government agent) has authority. Not only are there the obvious geographical limits on jurisdiction (for example, a Pennsylvania state trooper does not have jurisdiction over someone speeding in Ohio), but there is also the issue of "subject matter jurisdiction." For example, someone who collects taxes for the state of New York does not have the authority to ticket someone for double-parking. That is just not something under a tax collector's jurisdiction.

A crucial concept to understand at this point is that, contrary to what most Americans assume, the United States government does *not* have jurisdiction over everything that happens within the 50 states. On the contrary, the federal government's powers within the states are (in the words of James Madison) "*few and defined*," whereas each *state* government has general jurisdiction over most of what happens within that state's borders.

Most importantly—and again, this is not something most Americans hear very often—the federal government does *not* generally have jurisdiction over someone doing business in one of the 50 states. In one case, after explaining that Congress does have the power to regulate commerce which crosses state and country borders, the Supreme Court added this:

> "*But very different considerations apply to the internal commerce or domestic trade of the states. Over this commerce and trade Congress has no power of regulation nor any direct control. This power belongs exclusively to the states. No interference by Congress with the business of citizens transacted within a state is warranted by the Constitution, except such as is strictly incidental to the exercise of powers clearly granted to the legislature.*" [License Tax Cases, 72 U.S. 462 (1866)]

On the other hand, the federal government does, for example, have jurisdiction over business which involves foreign countries—or, as the Constitution puts it, Congress has the power "*to regulate commerce with foreign nations*"[19]. Might this fact have some bearing on Congress' taxing power?

[19] U.S. Constitution; Article I, Section 8, Clause 3

In Federalist #45, after saying that under the new Constitution the federal government would have only a few, limited powers (as quoted above), James Madison went on to explain that the federal power "*will be exercised principally on external objects, as war, peace, negotiation, and foreign commerce; with which last* [foreign commerce] *the power of taxation will, for the most part, be connected*." When the "Father of the Constitution" says that the federal government will get its funding primarily through taxing *foreign* commerce, that is certainly noteworthy, but does that have any relevance to an income tax?

The Peck Case

In the first few years after the 1913 income tax was imposed, several related cases reached the Supreme Court. One of those cases had to do with an American company "*engaged in buying goods in the several states, shipping them to foreign countries, and there selling them*." The company argued that applying an income tax to such a business would amount to a tax on state exports, which is forbidden by the Constitution (as mentioned before).

The Supreme Court rejected the company's argument (an argument unrelated to the topic addressed here), but made some very interesting comments in passing. After saying that the income tax act "*obviously could not impose a tax forbidden by the Constitution*," and that the income tax "*cannot be applied to any income which Congress has no power to tax*," the Court's ruling went on to say that because the Constitution grants Congress the general power to tax, as well as giving Congress specific jurisdiction over "*commerce with foreign nations*," the federal government could therefore "undoubtedly" apply an income tax to an American business engaged in *international* trade[20]. In other words, the court said that the taxing clause *and* the commerce clause combined undoubtedly authorize Congress to tax income from doing business which *crosses country borders*.

It is particularly noteworthy that the Supreme Court brought up the "commerce clause"—which gives Congress jurisdiction over international trade but *not* over trade occurring inside one of the states—when discussing what could be subject to a federal income tax. What might that imply about Congress' ability to tax the income of the average American? Unfortunately, in the Peck case the company did not question the taxability of any purely domestic income it might receive, so the Court did not address that issue at all. The Court explained why *foreign* commerce could "undoubtedly" be subject to a federal income tax, but left the question of purely domestic income hanging. Curiously, ever since then the Supreme Court has continued the pattern of not specifically saying one way or the other whether income earned by a U.S. citizen within one of the states is actually subject to the federal income tax.

[20] Peck v. Lowe, 247 U.S. 165 (1918)

Conspiracy?

When someone argues that the federal income tax is unconstitutional (a claim *not* made here), the government often cites the Supreme Court's ruling from Brushaber v. Union Pacific (240 U.S. 1 (1916)), another case occurring shortly following the advent of the 1913 income tax, in which the court held that the tax is Constitutional. What the government lawyers do not mention when citing that case (probably because they are unaware of it themselves), and what the actual court opinion in the case does not make clear, is that the case was about a nonresident alien (a foreigner) receiving income from within the United States. In other words, the case was again about "commerce with foreign nations."

"*Under the decision of the Supreme Court of the United States in the case of Brushaber v. Union Pacific Railway Co., decided January 24, 1916, it is hereby held that income accruing to nonresident aliens in the form of interest from the bonds and dividends on the stock of domestic corporations is subject to the income tax imposed by the act of October 3, 1913.*" [Treasury Decision 2313]

The above official statement, published by the Secretary of the Treasury, makes it abundantly clear what the case involved, while the Supreme Court's ruling says nothing about nonresident aliens, instead giving the impression that the case involved only a citizen of New York.

Putting the Pieces Together

So, shortly after the 1913 income tax was enacted, it was twice upheld as valid and Constitutional by the Supreme Court, as applied to two types of "*commerce with foreign nations*": income from *outside* the country being received by Americans (as in the Peck case), and income from *inside* the country going to nonresident *foreigners* (as in the Brushaber case).

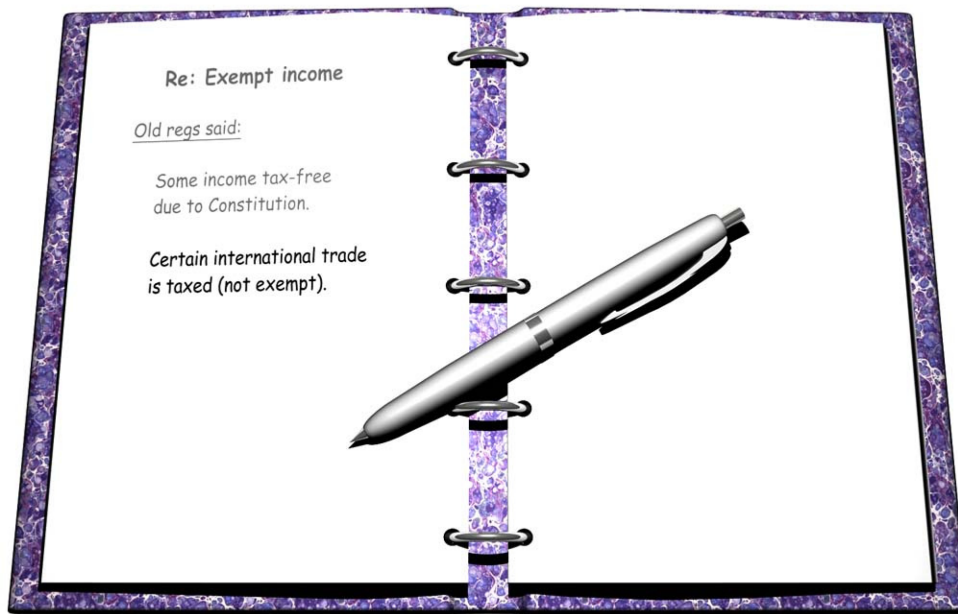
Now consider what the income tax *regulations* said in the years following those Supreme Court decisions. As shown above, the regs showed that income could be exempt from tax due to the tax code or because of the Constitution itself. But where do the regulations tell the reader just what is taxable and what is exempt?

"*39.22(a)-1 What included in gross income (a) Gross income includes in general* [numerous items of income listed] *derived from any source whatever, unless exempt from tax by law* [i.e., by statute or by the Constitution]*. . . . Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States.*" [26 CFR § 39.22(a)-1 (1956)]

Could the listing of those specific types of commerce (underlined above) constitute the regulation-writers' answer to the question of what is Constitutionally taxable? Would that not match what James Madison said about the federal government being funded mainly via taxes on *foreign* commerce? Is it only coincidence that only certain types of *international* commerce are listed as being taxable? (The term U.S. "possessions" refers to places such as Guam and Puerto Rico, which Congress *does* have general jurisdiction over, much the way that state governments have jurisdiction over state land[21].):

[21] U.S. Constitution, Article IV, Section 3

This gives us our second major "clue" worth noting.



In light of the wording of the regulation shown above (see Appendix A for the complete section), several points must be stressed here.

1) The regulation does not mention purely domestic income at all. Would it not have been easy for the regs to say that income from both foreign *and* domestic commerce must be included as "gross income" if that were in fact the case? Yet the domestic income of the average American is very conspicuously not mentioned at all, in several decades of equivalent regulations.

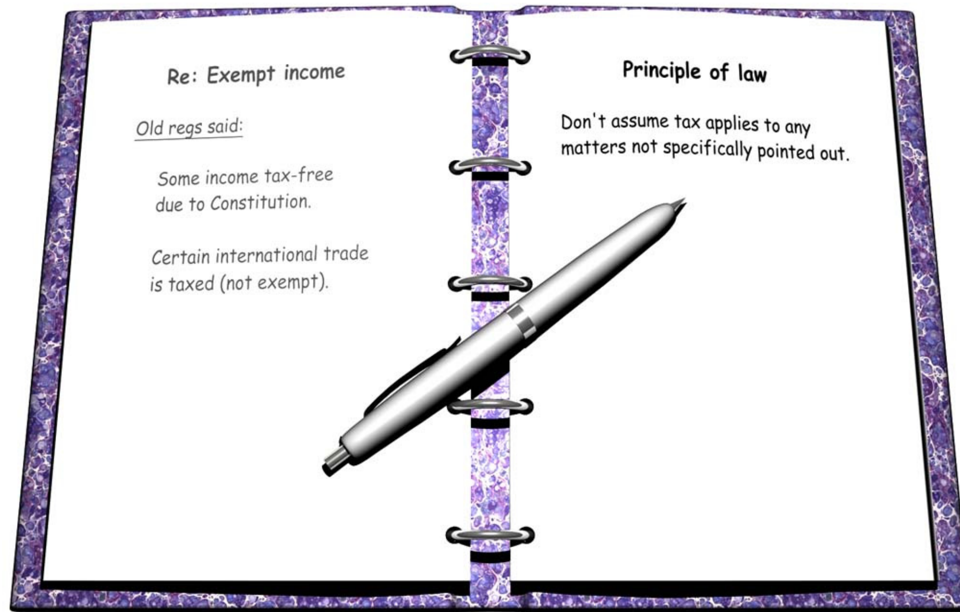
2) The statute which the above regulation "interprets" says nothing at all about foreign commerce, nonresident aliens, or federal possessions. So, why are those things mentioned in the regulation, unless for the purpose of spelling out the proper, limited Constitutional application of that very broadly-worded statute?

3) The regulations themselves raise the point of some income being exempt from tax because of the Constitution itself. If the underlined portions of the regulation above are *not* the answer to the question of what is Constitutionally taxable, where is that answer to be found? (It would obviously be improper, both legally and logically, for the law books to say that something is exempt, without ever saying what that something is.)

4) There is an old principle of law, expressed in Latin as "*inclusio unius est exclusio alterius*," which dictates that where the law specifically lists matters to which it applies, an "irrefutable inference" must be drawn that what was not listed was *intended to be omitted*[22]. This makes it even more significant that the official tax regulations specifically list certain types of international trade as being subject to the tax, without saying the same about the U.S. income of U.S. citizens. Certainly it would have been a simple matter to include that type of income on the list as well, if it were truly taxable. So why was it omitted?

[22] Black's Law Dictionary (Fifth Edition)

The fact that what the law does *not* say can be as significant as what it *does* say should be included on our list of important points to remember.



It is important to note that the question here is not what Congress *wanted* to tax, but rather what Congress is Constitutionally *allowed* to tax. In answering that question, the regulations referenced above are, in effect, saying that Congress has no power to tax the income of most Americans. So this is not about some mistake or "loophole" which Congress could simply "fix" with a new law; it is about the fact that it did not tax most Americans because it *could* not.

Cover-up #2: Hiding the List of Non-Exempt Income

For many years, one needed to look no further than the regulations generally defining "gross income" in order to learn that: 1) income is not subject to the tax if it is exempted by statute, or if it is excluded because of the Constitution itself, and; 2) income derived from commerce with foreign nations must be included in one's "gross income." If one was also aware of the principle of "*inclusio unius*," he might very well start to wonder whether the domestic income of most Americans is taxable after all.

As shown above, the admission that the Constitution itself exempts some income from tax has been obfuscated and relocated. The second example of intentional deception by the regulation-writers lies in the fact that after 1956 all mention of international trade and foreign commerce was also *removed* from the general regulatory definition of "gross income."

If, as the older regulations imply, income is taxable only when derived from certain types of international trade, should that not be one of the first and most obvious things for the regulations to say? So, what happened? Why the change? Once again, the truth was not removed entirely; it was instead moved many hundreds of pages away, and reworded into a far more complicated, confusing arrangement. Here is the form in which the truth is still told in the *current* regulations (with the first two steps having been mentioned above):

1) An obscure regulation, located *hundreds* of pages away from the general definition of "gross income," says that the "items" of income listed in Section 61 of the tax code make up "*classes of gross income*" (26 CFR § 1. 861-8(a)(3)).

2) Several paragraphs later, the regulations tell the reader to go to yet another section, "*which provides that a class of gross income may include excluded income*" (26 CFR § 1.861-8(b)(1)).

3) However, where the reader is directed (26 CFR § 1.861-8(d)(2)) there is no regulation, but only a pointer directing the reader to yet *another* section (26 CFR § 1.861-8T(d)(2)).

4) After giving rules about how deductions can or cannot be applied to taxable income or exempt income, that section defines "exempt income" to mean "*any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes*" (26 CFR § 1.861-8T(d)(2)(ii)).

5) Several sentences later, the regulation says this:

"*(iii) Income that is not considered tax exempt. The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:*
(A) In the case of a foreign taxpayer...
(B) In computing the combined taxable income of a DISC [Domestic International Sales Corporation] *or FSC* [Foreign Sales Corporation]*...*
(C) ...the gross income of a possessions corporation...
(D) Foreign earned income..." (26 CFR § 1.861-8T(d)(2)(iii))

That is the end of the list. (See Appendix B for the complete regulation.)

So, if you happen to be an American who receives wages, or business income, or interest, or any of the other items listed in Section 61, *and* if you happen to know where to look in the regulations, you are told that your type of income may include *exempt* income, and then you are directed to a list of types of commerce which are taxable (i. e., which are not exempt), and that list is all about trade which crosses country borders or involves federal possessions.

Though far more spread out and confusing in these current regulations, this is the same general arrangement found in the older regulations. Note that both lists, past and present, include the U.S. income of foreigners, certain foreign income of Americans, and income related to federal possessions (e.g., Guam and Puerto Rico). Conspicuously absent from both lists is the domestic income of the average American.

As with the older regulations, if the above-cited section is not a complete list of the types of commerce which are taxable under the Constitution, similar inescapable questions arise:

1) If purely domestic income were taxable, why is such income not mentioned on the list? In light of the principle of "*inclusio unius*," which dictates that one should assume that what the law does not specifically mention was *intended* to be omitted, would it not have been a simple and obvious thing to include domestic income on the list, if it were indeed taxable?

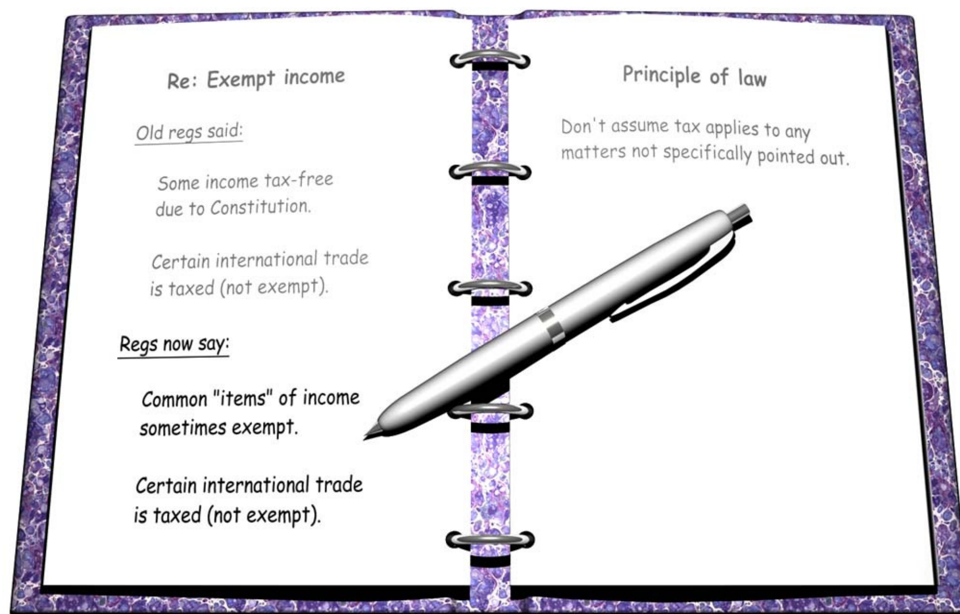
2) On what basis do the regulations say that all of those "items" of income in Section 61 are in some cases <u>exempt</u> (which the statute does not say), if not to account for the <u>Constitutional</u> limits on what is taxable?

3) The regulations specifically direct the reader to one small part of the regulations (26 CFR § 1.861-8T(d)), which provides that the common items of income "may include excluded income." If the above list of non-exempt types of commerce, which is located right where the regs lead the reader, is not the answer to the question of when the items are or are not taxable, where in that small section is such an answer to be found? (It does not take long to see that nothing else in that section comes close to answering the question.)

4) What is the purpose of that list of non-exempt, <u>international</u> trade, if not to answer the question about which commerce is Constitutionally taxable? The regulation-writers obviously must have had something in mind when including that list. What was it, if not that?

(Consider also how much clearer it would be if the regulation began with "*The following items are taxable*," instead of "*The following items are not considered to be exempt*." Though the meaning of the two is identical, using the double negative obfuscates the meaning.)

It's time to add another clue to our book.



Whether one looks at the regulations from 1926 or those from 2006, he is told that the common "items" of income are subject to tax unless they are exempt (which is really just a truism), and then is told that income from certain trade crossing country borders is <u>not</u> exempt.

For the regulations to fail to say specifically whether income from purely domestic commerce is also taxable—which the regs have consistently failed to say for over 90 years—is either the result of the largest typo and/or oversight in history, or the result of dishonest lawmakers not wanting to come right out and plainly admit the truth, which is that the income of most Americans is not subject to the federal income tax. Of course, an almost unimaginable amount of wealth and power now depends upon such an admission *not* being made and the truth being *covered up*. And the evidence demonstrates that that is exactly what has been done, and what continues to be done, by some people inside the federal government.

Taxable Activities

Is the federal "income tax" a tax upon income? If that question seems strange, the answer will no doubt seem even stranger.

"*The income tax is, therefore, not a tax on income as such. It is an excise tax with respect to certain activities and privileges which is measured by reference to the income which they produce. The income is not the subject of the tax: it is the basis for determining the amount of the tax*." [U.S. Congressional Record, March 27, 1943 (page 2580)]

Those are the words of F. Morse Hubbard, a former legislative draftsman for the U.S. Treasury Department (one of those whose job it is to write tax statutes and regulations). Unfortunately, and somewhat suspiciously, Mr. Hubbard did not go on to describe just what those "certain activities and privileges" are. (Mr. Hubbard's comments coincide perfectly with the fact that the Supreme Court describes "indirect" taxes—the category in which income taxes inherently belong—as being taxes upon "*certain commodities, privileges, particular business transactions, vocations, occupations, and the like*." [23].)

The general statutory definition of "gross income" talks about different kinds of income, but says nothing about any particular activities or privileges. So, does some *other* part of the law spell out what those activities are? (Again, even the most basic principles of both law and logic dictate that the law must say what it applies to.) If the law were to specify a certain activity as being taxable, might it look something like this?:

"*A nonresident alien individual engaged in trade or business within the United States... shall be taxable as provided in section 1*." [26 USC § 871(b)]

Or like this?:

"*A foreign corporation engaged in trade or business within the United States... shall be taxable as provided in section 11*." [26 USC § 882(a)]

(Note: Section 1 of the tax code imposes a tax upon the "taxable income" of every individual, whereas Section 11 imposes the tax on the "taxable income" of every corporation.)

[23] Flint v. Stone Tracy, 220 U.S. 107 (1911)

Income Versus Commerce

The single most important distinction to understand here is the difference between types of income and types of commerce. The two concepts are distinct (although at first easily confused), and each is an essential ingredient in understanding the law. In short, the federal income tax applies only when a taxable item of income derives from a taxable type of commerce. If either the income *or* the commerce is not taxable, the tax does not apply.

A simple example demonstrates the importance of this point. Suppose there are two Canadians, one of whom works, lives, and does business exclusively in Canada, while the other has some investments and business dealings in the United States. Each person receives various potentially-taxable "items" of income (e.g., wages, interest, business income, dividends), but only the *second* one actually owes any taxes to the U.S. government, because only his income derives from a type of commerce over which the U.S. government has any jurisdiction. As a nonresident alien (under U.S. law), the second person is benefiting from the privilege of doing business in the U.S., and is engaged in a particular activity (or type of commerce) which is specifically shown by the tax code to be taxable (see 26 USC § 871(b), shown above).

Were the receipt of income, all by itself, enough to create a tax liability, then over a billion foreigners who have no economic dealings with the U.S. would owe U.S. income taxes—which is not and cannot be the case. While that may be obvious, most people make the mistake of assuming that the federal government *does* have general jurisdiction over all business happening inside the 50 states, when in reality it does not, any more than it has general jurisdiction over all business occurring in Canada.

While federal courts have fluctuated somewhat over the years in their opinions about which federal excise taxes are valid and which constitute an unconstitutional attempt to control matters beyond Congress' jurisdiction, consider the following: The income tax code includes extensive behavioral controls in the form of rewards and punishments. For example, while the Code economically penalizes people for being married, or for being self-employed, it also rewards those who adopt children (Section 23 of the tax code), have a mortgage (Section 25), pay a college tuition (Section 25A), produce alternative fuels (Section 29), use an electric car (Section 30), employ American Indians (Section 45A), and so on. The controls over insurance, savings and investments are also extensive.

When such matters involve someone living and working in one of the states, the federal government has no Constitutional authority to control, reward, or punish such behaviors and economic decisions, whether that control is exerted by either direct regulation or tax policy. As the Supreme Court put it, "*If, in lieu of compulsory regulation of subjects within the states' reserved jurisdiction, which is prohibited, the Congress could invoke the taxing and spending power as a means to accomplish the same end, clause 1, Section 8 of Article I* [of the U.S. Constitution] *would become the instrument for total subversion of the governmental powers reserved to the individual states*."

Congress is, on the other hand, allowed to use so-called tax laws to control matters that are otherwise under federal jurisdiction, but it may not overstep the limits of its authority by disguising a regulation as a tax. "*The power of taxation, which is expressly granted, may, of course, be adopted as a means to carry into operation another power also expressly granted, but resort to the taxing power to effectuate an end which is not legitimate, not within the scope of the Constitution, is obviously inadmissible*." As a result, if only those engaged in international trade can have taxable income—as the law shows—then only those engaged in *international* trade are subject to all of the rewards and punishments of the tax code, and so Congress is merely regulating what the Constitution specifically allows it to regulate: "*commerce with foreign nations*." (As an aside, Congress may not control purely intrastate decisions and behaviors by way of "tax breaks" any more than it may do so via penalties for noncompliance. "*The Congress cannot invade state jurisdiction to compel individual action; no more can it purchase such action.* ")[24]

Subchapter N

In one way, the limits of Congress' power to tax, and the limits on which income is therefore subject to the federal income tax, are "hidden in plain sight" in the current tax code. The income tax, which is found in "Chapter 1" of the federal tax code, is divided into numerous "subchapters." Subchapter N is titled "*Tax based on income from sources within or without the United States*." As the name implies, this is the part of the law that describes the situations in which domestic income and foreign income are taxable. In other words, this is where the law deals with the issue of *commerce*, while other parts of the law deal only with items of *income*. Subchapter N is divided into five "parts," the titles of which are as follows:

SUBCHAPTER N

Tax Based on Income From Sources Within or Without the United States

Part I - Determination of Sources of Income

Part II - Nonresident Aliens and Foreign Corporations

Part III - Income from sources without the United States

Part IV - Domestic International Sales Corporations

Part V - International Boycott Determinations

Even a cursory examination of Parts II through V shows that while certain domestic income of *foreigners*, certain *foreign* income of Americans, and other *international* matters are discussed, there is no mention at all of the domestic income of the average U.S. citizen. In addition to the sections about nonresident aliens and foreign corporations shown above (Sections 871 and 882), these parts of the law include sections about foreign tax credits (Section 901 and following), foreign earned income (Section 911 and following), those living and/or doing business in federal possessions (Section 931 and following), and so on. This matches precisely what the regulations, past and present, list as the taxable types of commerce.

[24] All quotations in paragraph from United States v. Butler, 299, U.S. 1 (1936)

Of note, in keeping with the principle of "*inclusio unius*," the U.S. Supreme Court has stated, "*In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out*"[25]. The same ruling went on to say that, in case of doubt, taxing statutes are to be "*construed most strongly against the government, and in favor of the citizen*." So for the tax code to specifically point out that certain types of *international* trade are taxable, while failing to say one word about purely *domestic* commerce, is very significant. (Again, if the average American's income were taxable, it would certainly be a simple thing to add a section to the law specifically stating that. But for over *ninety years* it has never been done.) But it is in Part I of Subchapter N ("*Determination of Sources of Income*") where all the pieces really come together to form a complete picture, not only of the very limited nature of the tax, but also of the efforts to *cover up* the limited nature of the tax.

Section 861

While one can quote what a certain section of law says, one cannot cite a *lack* of statement in the law. In other words, it is easy to support a claim that the law says "X," but it is far more difficult to support a claim that *nowhere* does the law say "Y." And it is primarily that fact which has kept the public in the dark about the proper application of the federal income tax: the ease with which one can assume that somewhere in the thousands upon thousands of pages of statutes and regulations, it must say that the income of the average American is taxable. One section (as demonstrated above) might only list certain international trade as being taxable, but who knows what some other sections somewhere else in the law might show?

If the average American approaches the tax code starting with the assumption that he owes the tax (though that is the opposite of the way the Supreme Court says one should read the law), no single statement in the law will directly contradict that assumption. Nor, however, will any statement in the law confirm it. That is proper legally, as the law is required only to specify what is taxable—it need not specify what is exempt. Technically speaking, therefore, if you assume that your income is taxable when the law does not actually say so, that is your mistake, not a defect in the law. Morally and ethically, however, for government lawyers to go so far out of their way to avoid specifically telling tens of millions of Americans whether they owe the tax clearly amounts to fraud; it is a lie by omission, which in a case such as this is no less despicable than a conventional lie.

But how does one expose such a lie, when the false assumption is so universally accepted as the gospel truth, and when the law is so ridiculously complicated and voluminous? Rather than trying to prove that none of the thousands of pages of tax statutes and regs make a particular statement (e.g., that income from purely domestic commerce is taxable), it is possible to dramatically narrow down where the law would make such a statement, so that if the statement is not found in that location, one can safely assume that it does not exist anywhere in the law. In this case the question will be, For whom is U.S.-source (domestic) income taxable? Before determining the actual answer, it is best to isolate where in the law the answer is to be found. Conceding that certain foreign income is taxable for U.S. citizens, the question is whether a U.S. citizen can have taxable income from sources within the United States. Where would the law books answer such a question?

[25] Gould v. Gould, 245 U.S. 151 (1917)

"*Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined.*" [26 CFR § 1.861-8]

The regulations could hardly state it more plainly than that. The chart below shows where in the tax code the above-referenced sections (861 through 863) are located.

SUBCHAPTER N
Tax based on income from sources within or without the United States

PART I: Determination of Sources of Income
- **Section 861** - Income from sources within the United States
  - 861(a) - Gross income from sources within United States
  - 861(b) - Taxable income from sources within United States
- **Section 862** - Income from sources without the United States
  - 862(a) - Gross income from sources without U.S.
  - 862(b) - Taxable income from sources without U.S.
- **Section 863** - Special rules for determining source
- **Section 864** - Definitions and special rules
- **Section 865** - Source rules for personal property sales

PART II: Nonresident Aliens and Foreign Corporations
PART III: Income from Sources Without the United States
PART IV: Domestic International Sales Corporations
PART V: International Boycott Determinations

While earlier portions of the law give numerous rules concerning which items of income can be taxable, it is immediately apparent that Subchapter N is the part of the law which addresses the issue of commerce: determining when income from *inside* the U.S. is taxable, and when income from *outside* the U.S. is taxable. The regulations make the distinction well, saying that "*Section 61 lists the more common items of gross income*," and later saying that "*section 861 and following... and the regulations thereunder determine the sources of income for purposes of the income tax*"[26]. In fact, from 1954 to 2001, several major printings of the tax code (USC, USCA and USCS), under Section 61 itself—which generally defines "gross income" and lists various items of income—all contain cross-references such as the following:

"*Income from sources –*
Within the United States, see section 861 of this title
Without the United States, see section 862 of this title" [Cross-reference under 26 USC § 61]

Such a cross-reference is still found in the United States Code Service (USCS) printing of the tax code, while all such cross-references in the USC and USCA printings were removed after 2001. Prior to 1954, the cross-reference was part of the actual text of the statute. The section generally defining "gross income" back then (Section 22) said that "*For computation of gross income from sources within and without the United States*," one should refer to the predecessor of the current Section 861 and following (which back then was Section 119).

[26] 26 CFR §§ 1.61-1, 1.861-1

The purpose of Section 861 (and following sections) is also summed up nicely in the Treasury Department's "Cumulative Bulletin," as follows:

"*Rules are prescribed for determination of gross income and taxable income derived from sources within and without the United States, and for the allocation of income derived partly from sources within the United States and partly without the United States or within United States possessions. §§ 1.861-1 through 1.864. (Secs 861-864; '54 Code.)*" [Treasury Decision 6258]

While the earlier sections of the tax code (including Section 61) deal with specific items of income, they say nothing about who is receiving the income or where (geographically) it is coming from. In other words, they do not at all address the commerce from which the income derives. The citations above, however, make it quite clear that commerce is what Subchapter N (particularly Section 861 and following) is all about. It is not unusual for federal law to follow this pattern: imposing a requirement in very general terms in one section, while other sections limit that requirement to matters involving the types of commerce which the Constitution puts under federal jurisdiction.

For example, one section of federal law prohibits any "employer" from discriminating against individuals based upon their race, religion, etc. (42 USC § 2000e-2), while another section defines the term "employer," for purposes of that law, to mean an employer doing business related to interstate or international commerce, or commerce in federal possessions (42 USC § 2000e(g)). In this way apparently broad requirements are kept in line with the Constitution by limiting their applicability to commerce which Congress has the authority to regulate. Likewise, while the earlier sections of the tax code (e.g., Sections 1, 61 and 63) impose what at first glance appears to be an all-encompassing tax, Subchapter N of the Code (Section 861 and following) limits the tax to types of commerce which are Constitutionally under federal jurisdiction.

Because section numbers can be difficult to remember, and because the numbering methods are slightly different for statutes and regulations, the chart below is included to help keep the pertinent sections in mind.

SUBJECT	STATUTE	REGULATION
Income from inside the U.S. Domestic "gross income" Domestic "taxable income"	§ 861 § 861(a) § 861(b)	§ 1.861-1 §§ 1.861-2 through -7 § 1.861-8 and following
Income from outside the U.S. Foreign "gross income" Foreign "taxable income"	§ 862 § 862(a) § 862(b)	§ 1.862-1 § 1.862-1(a) §§ 1.862-1(b), 1.861-8
Income from inside and outside U.S.	§ 863	§ 1.863-1

Section 863 gives rules for dividing up income which includes both foreign and domestic income (such as from selling products in multiple countries) into "within" and "without" income. While this may come into play when determining the taxable domestic income of international corporations (for example), it is not relevant to whether the income of the average American who lives and works only in the 50 states is taxable. For that person, Section 861 and its regs are the pertinent sections.

In case any doubt remains about the purpose and function of these sections, consider what the very first section of regulations under Section 861 says—and has said for over fifty years:

"*§1.861-1 Income from sources within the United States*
(a) Categories of income. Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. ... The statute provides for the following three categories of income:
(1) Within the United States The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the [allowable deductions]. See §§ 1.861-8 and 1.863-1.
(2) Without the United States ...
(3) Partly within and partly without the United States ...
(b) Taxable income from sources within the United States.
The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(l) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section."
[26 CFR § 1.861-1, see Appendix C for complete section]

The Expert Blunder

Based on the above, it may seem patently obvious at this point, even to those not well versed in the law and not accustomed to reading tax laws, that Section 861 and the related regulations are the place to look to determine one's taxable domestic income. Over and over again the lawbooks state, unequivocally and unconditionally, that those are the sections to use to determine one's taxable income from sources within the United States.

Here is the surprising part: today's tax professionals *do not* use Section 861 and its regulations to determine the taxable domestic income of their clients. In fact, they do not consider the issue of "commerce" at all (in the vast majority of cases); they simply assume that domestic income is always taxable for Americans, and never stop to see whether the law actually *says* that. After falsely assuming that income from purely domestic commerce must be taxable, they then apply the various deductions, statutory exemptions, and other special rules—which they *are* familiar with—to come up with a bottom-line figure. But they skip altogether the first and most fundamental step: determining whether, based upon the type of *commerce* it derives from, the income is even subject to the tax to begin with. They simply *assume* that it is, and go from there.

This is another instance in which the "conventional wisdom" about the income tax, as believed and repeated by the vast majority of CPAs, attorneys, and other tax professionals (including those who work for the IRS), dramatically clashes with what the law books actually state. Unfortunately, when forced to choose between the assertions of a herd of self-proclaimed tax "experts" and obviously contradictory evidence from the law itself, many people still side with those who profess to being knowledgeable on the subject.

There could hardly be a more dramatic difference between what the law says one should do and what tax preparers actually do. When it comes to the government's own law books, all roads lead to 861 regarding income from sources within the United States. Yet very rarely (such as when a case does involve international trade) will a tax professional reference those sections at all. Many do not even know those sections exist. With that in mind, below is a list of just some of the things from the actual law books which direct the reader to Section 861 and its regulations regarding domestic "gross income" and domestic "taxable income." (The first five items on the list are quoted from above.)

1) The title of Section 861, and the titles of its subsections..

2) The first section of related regulations (1.861-1).

3) The first sentence of the regs under 861(b) (namely, 1.861-8),

4) The cross-references under Section 61.

5) Treasury Decision 6258.

6) The regulations related to Section 863, which say that "*The taxpayer's taxable income from sources within or without the United States will be determined under the rules of Secs. 1.861-8 through 1.861-14T.*"[27]

7) The regulations related to Section 862, which say that one's taxable *foreign* income "*shall be determined on the same basis as that used in Sec. 1.861-8 for determining taxable income from sources within the United States*."[28]

8) Other regulations under Section 863, which identify 1.861-1 through 1.863-5 of the regs as giving the rules "*for determining the gross and the taxable income from sources within and without the United States*."[29]

9) Numerous other sections of the tax code (such as Sections 79, 105, 410, 414 and 505) which identify Section 861 as the section which determines what constitutes "*income from sources within the United States*."

[27] 26 CFR § 1.863-1(c)
[28] 26 CFR § 1.862-1(b)
[29J 26 CFR § 1.863-6

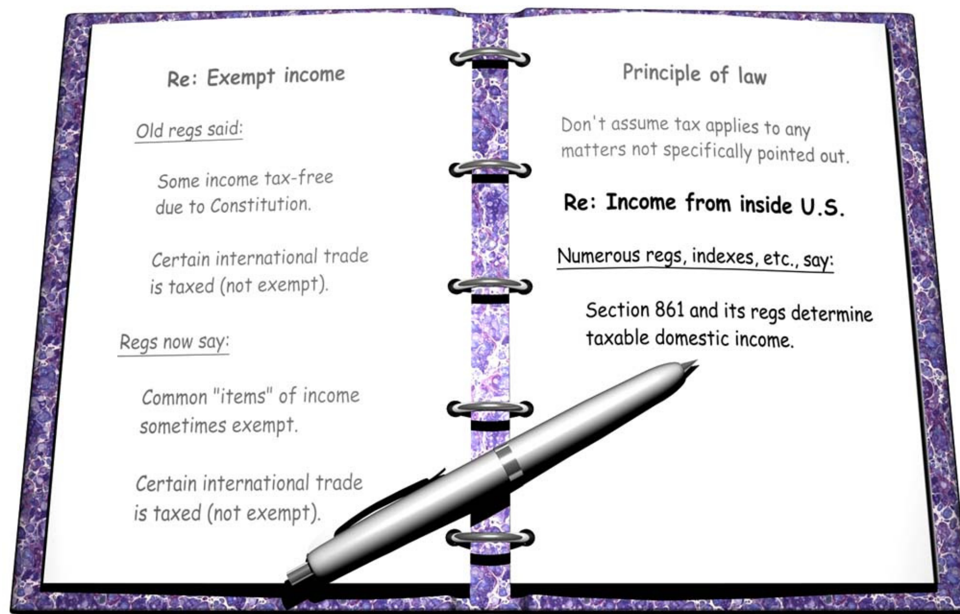
10) The index of the Code of Federal Regulations, which, under "Income Taxes," refers the reader to the regs under 861 and following regarding both "*Determination of sources of income*" and "*Income from sources inside or outside U.S.*"

11) The indexes of the tax code (including the USC, USCA and USCS printings), which contain entries such as the following:

- Under "*Sources of income, Within the U.S.*," the reader is referred to Section 861.
- Under "*Gross income, Sources within U.S.*," the reader is referred to Section 861.
- Under "*Deductions, Taxable income from within U.S.*," the reader is directed to Section 861.
- Under "*Taxable income, Sources within U.S.*," the reader is directed to Section 861.

(As a reminder, Section 63 of the tax code explains that, in general, taxable income equals gross income minus deductions; and under all three of those concepts, the indexes of the Code point to Section 861 regarding income from *inside* the U.S. Also of note, there are *no* regulations under Section 63 explaining how to determine taxable income.)

So let us add this point to our clue book.



Pay No Attention to the Section Behind the Curtain!

Since the mid-1990s, when the issue addressed in this report first began to be exposed to a significant number of people, the status quo tax professionals, both inside and outside the government, have responded the way entrenched, highly-esteemed and well-paid so-called experts usually respond when conventional wisdom is challenged: with a heavy dose of condescending ridicule (e. g., "That's nonsense!"), a helping of thinly-veiled and not-so-thinly-veiled threats (e.g., "You'll get in trouble if you believe that!"), and very little actual substance.

Far and away the most popular response from the self-proclaimed tax pros—when the response has consisted of saying anything more than “Frivolous!”—can be summed up as “You aren’t supposed to use Section 861!” The attempted justifications for that assertion have varied widely, often contradicting each other, but the true rationale behind the claim does not amount to anything more scholarly than this: “We’ve never used those sections, so you shouldn’t either!”

Oddly, their claims about who should use 861 fluctuate, including claims from government officials, who have (at various times) asserted that: 1) only foreigners should use those sections; 2) only Americans with foreign income should use those sections; 3) only Americans with foreign and domestic income should use those sections[*]; 4) only those who need to “apportion” income and/or deductions between foreign and domestic sources should use those sections, and less frequently; 5) all Americans should use those sections. If there is a common theme among such claims (excluding the last one), it boils down to this: “Look there only if those sections show your income to be taxable; otherwise, don’t look there, and just assume your income is taxable anyway.” (Oddly, those who claim that 861 and related sections should be used by U.S. citizens only if they have both foreign *and* domestic income fail to explain why, if such people *do* use those sections, their *foreign* income shows up as taxable, while their domestic income does *not*, as will be shown below.)

As for the law itself, nowhere does it say that 861 and its regs should be used only by certain people, or only in certain unusual circumstances. On the contrary, numerous citations (such as those shown above) state quite plainly, without any qualifiers or exceptions, that those sections give the rules for determining one’s “taxable income from sources within the United States.” At this point it is probably not difficult for the reader to guess why both private tax professionals and government employees (especially those working for the IRS) do not want people to use 861 and its regulations to determine their taxable income: because, as will be thoroughly proven below, those sections do not show the income of the average American to be taxable.

Getting to the Root

Now that it has been firmly established that Section 861 of the tax code, and the regulations related to that section, are the place to look to determine who can have taxable domestic income, it is time to delve into what those sections actually say. However, the current sections alone in many ways resemble a “crime scene” after the perpetrator has had time to conceal or remove most of the evidence. While in the current law books there are still enough bits and pieces to reconstruct the truth, the whole picture becomes a lot more clear—and a lot more sinister—when considered in chronological order, starting from the very beginning. With that in mind, the following examines how a particular portion of the law—which today is Section 861—has “evolved” over the years.

It is important here for the reader to understand that the tax code is not discarded and rebuilt from scratch every year (or even every decade), like throwing away an old car and getting a new one. On the contrary, the current tax code is really just the original 1913 income tax, but with many, many amendments having been made over the years, much like a very old car that has had a lot of little pieces replaced, various parts tinkered with, and several paint jobs—but is still the same car underneath. Whether with a car or a law, the best way to truly understand the essence of the thing is to see what it looked like before all of the adjustments and tinkerings occurred.

This is what Section 861 looked like, eighty years and several "paint jobs" ago:

"*Sec. 217. (a) In the case of a nonresident alien or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:*
(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise;
(2) The amount received as dividends from a domestic corportation...;
(3) Compensation for labor or personal services performed in the United States;
(4) Rentals or royalties from property located in the United States...;
(5) Gains, profits, and income from the sale of real property located in the United States;
(b) From the items of gross income specified in subdivision (a) there shall be deducted [the allowable deductions]. *The remainder, if any, shall be included in full as net income from sources within the United States*." [Section 217, Revenue Act of 1925]

While that section mentioned only two types of *individuals*, Section 232 of the same Act added the equivalent corporations, saying that "*in the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217*." So the section was about: 1) foreigners (individuals and companies), and 2) Americans (individuals and companies) "*entitled to the benefits of section 262*," which meant that they received the majority of their income from inside federal *possessions*, such as Guam and Puerto Rico. The "benefit" was that only their income from within the U.S. (and not their income from within the possessions) would be subject to the tax. For the moment, the reader need only understand that only those doing business in federal *possessions* could be "*entitled to the benefits of section 262*." (See Appendix E.)

With those things in mind, it becomes easy to distill the section down and concisely express its meaning. The section lists various common types of domestic income, including (among other things) payment for labor performed inside the United States and interest on U.S. investments, and says that in the case of foreigners, and in the case of Americans with possessions income, such income constitutes domestic income and, after subtracting the allowable deductions, constitutes taxable domestic income.

Consider that carefully and let its legal significance sink in. Why would the law say that those types of U.S.-source income are taxable for foreigners and for *certain* Americans (those with possessions income), instead of saying that such income is taxable for all Americans (as "conventional wisdom" says it is)? Why, for example, would the law specifically point out that compensation for services performed in the U.S. is to be included as taxable domestic income in the case of just some Americans in unusual circumstances? Are not domestic wages taxable for *all* Americans? Section 217 back then obviously did *not* say so. Why not?

Now recall that that section is what eventually became the current Section 861—the primary section to use (along with its regulations) to determine one's taxable income from sources within the U.S. But what would the average American find there, if he attempted to use the section to do that? He would find a statute which specifically points out that U.S. wages are taxable for Americans who also have *possessions* income (as well as for foreigners), but which says nothing at all about the wages of the average American worker. So, what is the reader to make of all that?

"*Inclusio unius est exclusio alterius. The inclusion of one is the exclusion of another. The certain designation of one person is an absolute exclusion of all others. ... This doctrine decrees that where law expressly describes* [a] *particular situation to which it shall apply, an irrefutable inference must be drawn that what is omitted or excluded was intended to be omitted or excluded*." [Black's Law Dictionary, 6th Edition]

"*In the interpretation of statutes levying taxes it is the established rule not to... enlarge their operations so as to embrace matters not specifically pointed out*."
[Gould v. Gould, 245 U.S. 151 (1917)]

With those principles in mind, if the law points to one section as the place to look to determine when domestic income is taxable, and that section specifically says that domestic income is taxable for certain people *other than you*, there is only one logical conclusion to be drawn: in your case, domestic income is not taxable.

Cover-up #3: Obscuring For Whom Domestic Income Is Taxable

No one could possibly mistake the old Section 217 (from 1925) to mean that domestic income is taxable for *all* Americans. (See Appendix D.) At the time, that section was only *four* section numbers away from the general definition of "gross income (back then Section 213), instead of *eight hundred* numbers away, as it is now (61 versus 861).

(Note also how well all the pieces fit together. The 1920s regulations generally defining "gross income" mentioned the foreign income of Americans, as well as the domestic income of: 1) nonresident aliens and foreign corporations, and 2) Americans (individuals and corporations) with possessions income—precisely the same things mentioned in Section 217 of the 1920s statute, dealing with who could have taxable income from inside the U.S.)

Less than a decade later, however, a rather conspicuous change occurred to the wording of that section of law (what would eventually become Section 861). Compare the following:

<u>Section 217 (1925)</u>	<u>Section 119 (1939)</u>
"*(a) In the case of a <u>nonresident alien</u> or of a citizen <u>entitled to the benefits of section 262</u>, the following items of gross income shall be treated as income from sources within the United States:* *(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise;* *(2) The amount received as dividends from a domestic corporation…;* *(3) Compensation for labor or personal services performed in the United States;* *(4) Rentals or royalties from property located in the United States…;* *(5) Gains, profits, and income from the sale of real property located in the United States*; *(b) From the items of gross income specified in subdivision (a) there shall be deducted the* [allowable deductions]. *The remainder, if any, shall be included in full as net income from sources within the United States.*"	"*(a) Gross income from sources in United States. – The following items of gross income shall be treated as income from sources within the United States:* *(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise;* *(2) The amount received as dividends from a domestic corporation…;* *(3) Compensation for labor or personal services performed in the United States;* *(4) Rentals or royalties from property located in the United States…;* *(5) Sale of Real Property. –Gains, profits, and income from the sale of real property located in the United States.* *(b) Net income from sources in United States. – From items of gross income specified in subsection (a) of this section there shall be deducted the* [allowable deductions]. *The remainder, if any, shall be included in full as net income from sources within the United States.*"

Though most of the section remained essentially the same, in 1932 the phrase about nonresident aliens and citizens with possessions income (those "entitled to the benefits of section 262") mysteriously *vanished* from the section. First, let us establish that these really are corresponding sections: the one on the left is what *became* the one on the right. The chart below shows the "genealogy," if you will, of what is now Section 861:

Subject	**1921 - 1931**	**1932 - 1953**	**1954 - present**
Domestic gross income	§ 217(a)	§ 119(a)	§ 861(a)
Domestic taxable income	§ 217(b)	§ 119(b)	§ 861(b)
Foreign gross income	§ 217(c)	§ 119(c)	§ 862(a)
Foreign taxable income	§ 217(d)	§ 119(d)	§ 862(b)
Income from inside and outside U.S.	§ 217(e)	§ 119(e)	§ 863

So, concerning taxable domestic income, for example, section 217(b) from 1921 became section 119(b) of the 1932 code, and later became section 861 (b), which is what it still is today. (The Supreme Court case of Commissioner v. Wodehouse, 337 U.S. 369 (1949), together with the notes under the tax acts of different years, and the relatively recent Treasury Decision 8687 all confirm the path of "evolution" of these sections as shown above.)

Why, then, when Section 217 became Section 119, was there such a significant change in the wording of the beginning of the section? Why did it stop mentioning foreigners and those with possessions income? Was Congress "fixing" the section, to make it say that domestic income was taxable for *everyone*? Or had Congress expanded the law, to make the average American's income taxable, when it had not been before?

Neither. The correct application of the law did not change at all. The *regulations* under both sections (217 and 119) were nearly identical, with each talking about foreigners, and about citizens with possessions income. So, for example, while Section 119 of the 1939 statutes listed various types of domestic income, the related regulations stated quite plainly for whom those types of income were taxable.

Statute:
"*Net income from sources in United States.—From the items of gross income specified in subsection (a) of this section there shall be deducted the* [allowable deductions]*. The remainder, if any, shall be included in full as net income from sources within the United States*." [Section 119(b) (1939 code)]

Regulation:
"*From the items specified in section 119(a) as being derived specifically from sources within the United States there shall, in the case of non-resident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted the* [allowable deductions]*. The remainder shall be included in full as net income from sources within the United States*." [Regulation under Section 119(b) (26 CFR § 39.119-10 (1945))]

Several other sections of related regulations (e.g., sections 29.119-1 and 29.119-9) also mentioned foreigners and those with possessions income, and no one else. As another example, while subsection 119(a)(1) of the statutes talked about "interest" on U.S. investments, without specifying for *whom* such income was taxable, the related regulations said this:

"*29.119-2. Interest.*
There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States, or domestic corporations which are entitled to the benefits of section 251, all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise [with limited exceptions]."

If domestic "interest" were taxable for anyone who receives it, which is what "conventional wisdom" says, there is no reason whatsoever for the regulations to have said what they said. To specifically point out that such income is taxable for *certain* people, engaged in certain types of *international* commerce, without making any mention of the returns on investments of the average American, is very significant. (As an aside, Congress must approve federal agency regulations before they are finalized, so this was not a disagreement of some kind; Congress was well aware of, and gave its blessing to, the "interpretation" expressed in those regulations.)

If, when Section 217 turned into Section 119, the scope of the law did not change (as the regulations clearly demonstrate), what possible reason could there have been to remove from the statute the phrase specifically saying *who* could have taxable income from within the U.S.? No honest or justifiable reason comes to mind, though a possible deceptive motive is obvious: to mislead the American people regarding the issue of who actually owes federal income taxes.

And to a large extent, it worked. The current Section 861 is substantially the same as Section 119 from 1939, and by itself still does not mention for whom the listed types of domestic income are taxable. As a result, some tax professionals today (though they are in the minority) argue that Section 861 does mean that U.S. income is taxable for everyone. For example, they cite Section 861(a)(3) to mean that "*compensation for labor or personal services performed in the United States*" is taxable for *everyone*—an understandable mistake if one reads only the current Section 861 by itself—and a mistake which the change in wording of the section seems to have been *intended* to cause.

The general wording of Sections 861 and 862 categorizes *all* income—whether taxable or not—as either "within" income or "without" income. If one reads Section 861, all by itself and out of context, to mean that the listed types of domestic income are taxable for everyone in all situations (which a few self-proclaimed tax "experts" have done), he would also have to read the nearly identical wording of Section 862 to mean that the types of *foreign* income listed there are also always taxable for everyone. The conclusion would be that all income from anywhere is taxable for everyone on the planet—which not only is obviously untrue, but also would render all of the within/without rules utterly pointless. Why distinguish between the two, only to then say that both are always taxable no matter who receives them?

The current regulations under 861, as will be shown below, still demonstrate that the types of domestic income listed in Section 861 itself are taxable only for *certain* people in certain circumstances, though it explains that fact in an extremely convoluted and confusing manner. But the legislative history of the section makes the truth crystal clear. No one, for example, would misunderstand the following—from the "great grandfather" of Section 861—to mean that U.S. wages are taxable for everyone.

"*(a) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:...*
(3) Compensation for labor or personal services performed in the United States;...
(b) From the items of gross income specified in subdivision (a) there shall be deducted [the allowable deductions]. *The remainder, if any, shall be included in full as net income from sources within the United States*." [Section 217, Revenue Act of 1925]

Some tax professionals today, not eager to address or respond to such evidence, insist that only current sections matter, and that everything else is obsolete and should be ignored. But that is not at all the case. As the IRS's own manual explains, the current language of the tax code "*does not solve every tax controversy*," and "*Courts also consider the history of a particular Code section*"[30]. For example, the Supreme Court in one case specifically referred back to the old Section 217 to help properly understand the meaning of Section 119 from 1939.[31] As another example, Treasury Decision 8687 (from 1996), in discussing what current regulations should say, refers all the way back to Section 217 from 1921. Both the Judicial and Executive branches of the federal government regularly reference so-called obsolete law to determine the correct meaning and application of *current* law. This is because they know that laws do not appear out of the blue every year, but are the result of a sort of statutory evolution.)

The Deception of 1954

Not much changed in the relevant sections between 1932 and 1954, with the exception of the disappearance of two sections of regs under Section 119 (Sections 39.119-1 and 39.119-9) which specifically mentioned nonresident aliens, foreign corporations, and American individuals and companies with possessions income. (Two other sections mentioning those things remained.)

Then, in 1954, the entire tax code underwent a major rearranging, renumbering, and in some cases, rewording. The old Section 119 of the statutes became the new Sections 861 through 864, with no significant change in the text of that part of the law. Those sections have remained essentially the same ever since. Of note, both houses of Congress, in their respective reports on the 1954 Code, stated that the application of that part of the law had not significantly changed. Those reports include the following:

SUBCHAPTER N - TAX BASED ON INCOME
FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

Part I - Determination of Sources of Income

§ 861. Income from sources within the United States
§ 862. Income from sources without the United States
§ 863. Items not specified in section 861 or 862
§ 864. Definitions

These sections, which are identical with sections 861-864 of the House bill, correspond to section 119 of the 1939 Code. No substantive change is made, except that section 861(a)(3) would extend the existing 90-day $3,000 rule in the case of a nonresident alien employee of a foreign employer to a nonresident alien employee of a foreign branch of a domestic employer.

[30] Internal Revenue Manual, Section 4.10.7.2.1.1
[31] Commissioner v. Wodehouse, 337 U.S. 369 (1949)

But while the correct application of this part of the law did not change, and while the text of the statute changed hardly at all, the related regulations underwent some dramatic (and very suspicious) changes. For example, compare how the first section of related regulations appeared, before and after 1954:

Before 1954 (§ 29.119-1)	After 1954 (§ 1.861-1)
Income from sources within the United States *Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States. ...* *The Internal Revenue Code divides the income of such taxpayers into three classes:* *(1) Income which is derived in full from sources within the United States;* *(2) Income which is derived in full from sources without the United States;* *(3) Partly within and partly without the United States* *The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.*	*Income from sources within the United States* *(a) Categories of income. Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. ... The statute provides for the following three categories of income:* *(1) Within the United States…* *(2) Without the United States…* *(3) Partly within and partly without the United States…* *(b) Taxable income from sources within the United States. The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a) (3) of this section.*

After the change, all mention of who could have taxable income from within the U.S. had been removed from the section. A similar, equally conspicuous change occurred at the same time to the main regulation which is to be used to determine taxable domestic income. Again, compare the section before and after the change.

Before 1954 (§ 29.119-10)	After 1954 (§ 1.861-8)
From the items specified in sections 29.119-2 through 29.119-6, inclusive, as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted [allowable deductions]*. The remainder shall be included in full as net income from sources within the United States.* [Section 29.119-10]	*From the items specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States there shall be deducted the* [allowable deductions]. *The remainder, if any, shall be included in full as taxable income from sources within the United States.*

Keep in mind, Congress specifically said that the application of this part of the law had not changed. So why, in one year, did the regulations say that domestic income is (after subtracting deductions) taxable for certain people engaged in certain types of commerce, and in the next year say simply that such income is (after subtracting deductions) taxable? No one would mistake the older section to mean that U.S. income is taxable for everyone, while almost anyone could and would mistake the newer section to mean just that.

Of note, both sections went on to give an example of how the section is to be applied to determine one's taxable domestic income. Note the one significant change:

Before 1954 (§ 29.119-10 example)	**After 1954 (§ 1.861-8 example)**
Example. A nonresident alien individual engaged in trade or business within the United States whose taxable year is the calendar year derived gross income from all sources for 1942 of $180,000, including there-in:...	*Example. A taxpayer engaged in trade or business for the taxable year gross income from all sources $180,000, one-fifth of which ($36,000) is from sources within the United States, computed as follows:...*

The rest of the example, including all the dollar amounts ($9,000 interest from a domestic corporation, $4,000 from dividends, $12,000 in royalties from U.S. patents, and $11,000 from the sale of real property) remained the same. The only real change was that the old section admitted that the example was about a *nonresident alien*, while the new section referred only to "a taxpayer." Why? Why might someone not want the reader to know that the example was about a foreigner? Because, of course, when the average American reads a section titled "*Computation of taxable income from sources within the United States*" (which was the title of the section right after 1954), the government gets a lot more money if the reader can easily misunderstand the section to mean that *his* domestic income is taxable, when in reality it is not. In other words, the reason for these changes to the regulations was an intent to deceive and defraud the American public. Another glaring example occurred in the section of regs which dealt with domestic "interest." Once again, a side-by-side comparison speaks for itself.

Before 1954 (§ 29.119-2)	**After 1954 (§ 1.861-2)**
Interest. There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States, or domestic corporations which are entitled to the benefits of section 251, all interest received or accrued, as the case may be, from the United States, and Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except... [some exceptions].	*Interest. (a) General. There shall be included in the gross income from sources within the United States all interest received or accrued, as the case may be, from the United States, and Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except...* [some exceptions].

Notice that the only change is the *removal* of the phrase specifying *who* had to include domestic "interest" in their gross income. If the law did not change (as Congress admitted), there is no benign explanation for such changes to the wording of the regulations. The only explanation is that the regulation writers did not want the general public to know that domestic income is *not taxable* for the average U.S. citizen.

(As a reminder, it was at the same point in time, just after 1954, when changes described above under "Cover-up #1" and "Cover-up #2" occurred, involving the removal of any mention of the Constitution itself exempting some income from taxation and the removal of the list of the non-exempt (taxable) types of income, which all related to *international* trade.)

The Mother of All Obfuscations

So, to review, the "evolution" of the relevant portion of the federal income tax laws (what is now Section 861 and related regs) can be summed up as follows:

- In the 1920s, both the statute (Section 217) *and* the related regulations stated quite plainly that domestic income (e.g., wages earned in the U.S., interest and dividends from U.S. investments, rents from property located in the U.S., etc.) was, after subtracting deductions, to be included in the taxable income of nonresident aliens, foreign corporations, and Americans (individuals and companies) who have possessions income. The sections very obviously were *not* saying that domestic income is taxable for all U.S. citizens.

- After 1932, the statute (Section 119) by itself no longer specified exactly for *whom* the listed types of domestic income were taxable, though the related regulations, virtually unchanged from before, still unmistakably stated that such income was taxable for foreigners, and for Americans with possessions income.

- Shortly after 1954, neither the statute *nor* the related regs specifically stated for whom domestic income was taxable. As a result, the average reader would almost certainly misread the sections to mean that U.S.-source income was taxable no matter who received it, unless the reader happened to know the history of the sections, and/or understood how the different parts of Subchapter N work together (as explained below).

- After 1977, one section of the regulations under Section 861 was dramatically altered. (Section 861 itself and the other regulations related to it remained essentially unchanged.) That one section which changed, Section 1.861-8, is related to 861(b) of the statutes ("*Taxable income from sources within United States*") and is repeatedly referred to as the section to use to determine one's "*taxable income from sources within the United States*."[32] The changes which occurred to that section after 1977 were extensive, and very telling.

[32] e.g., 26 CFR §§ 1.861-1(a)(1), 1.862-1(b), 1.863-1(c)

The most immediately apparent change was that, whereas the prior Section 1.861-8 filled about *one* page, the new version of the same regulation occupies more than *thirty* pages (which, incidentally, is about a dozen times as long as the statute it is supposed to "interpret," Section 861). Of note, there was no change at all to the statute to justify such an explosion in the length of the regulation.

The two most important things to note about the new Section 1.861-8 are that: 1) it tells the truth about the fact that U.S. source income is taxable only for certain people engaged in certain types of commerce (*not* most Americans); and 2) it does so in just about the most convoluted and confusing way possible. While trying to navigate your way through the tangled maze of "legalese" discussed below, keep in mind how brief, concise, and easily understandable this part of the law had been before (e.g., Section 217 from 1925).

After 1977, several new technical legal terms were used in Section 1.861-8, though those terms do not appear and have never appeared anywhere in the statutes, and had never before appeared anywhere in any other regulations. In other words, these terms were made up just for use in the new Section 1.861-8. Several of these new terms are defined below, first using language designed to be clear and understandable, and then the way they are explained in the actual regulations.

1) Operative Sections. As mentioned above, throughout Subchapter N of the tax code there are various sections which address specific types of commerce (such as a nonresident alien doing business in the U.S.). These sections, called "operative sections" by Section 1.861-8, include the sections shown in the list below.

SUBCHAPTER N

Tax Based on Income From Sources Within or Without the United States

PART I - Determination of Source of Income
PART II - Nonresident Aliens and Foreign Corporations
  Section 871 - Nonresident aliens doing business in the U.S.
  Section 882 - Foreign corporations doing business in the U.S.
PART III - Income From Sources Without the United States
  Section 904 - Limit on the foreign tax credit
  Section 911 - Foreign Earned Income
  Section 925 - Foreign sales corporations
  Section 931 - Citizens with possessions income
  Section 934 - Rules related to the Virgin Islands
  Section 936 - U.S. corporations with possessions income
  Section 941 - China Trade Act corporations
  Section 952 - Controlled foreign corporations
PART IV - Domestic International Sales Corporations
  Section 994 - Domestic International Sales Corporations
PART V - International Boycott Determinations
  Section 999 - International boycott matters

Note that all the sections deal with international trade or federal possessions; none relates to a U.S. citizen doing business only in the 50 states.

2) Specific Sources or Activities. Each operative section (listed above) describes a particular activity or type of commerce. For example, the "specific source or activity" described in Section 871 is a nonresident alien doing business inside the United States.

3) Statutory Grouping. The income generated by a particular activity described in an "operative section" makes up a "statutory grouping of gross income." For example, the income a nonresident alien receives from doing business in the U.S. falls into a "statutory grouping."

4) Residual Grouping. The income received from any activity *other* than the activity described in an "operative section" constitutes a "residual grouping of gross income" (which is often exempt from tax). For example, the income which a foreigner receives from doing business in his own country (not from doing business in the U.S.) makes up a residual grouping, which in that case is not taxable.

Keeping the above terms in mind, below are some excerpts from the regulations found in Section 1.861-8.

"*(ii) Relationship of sections 861, 862, 863(a), and 863(b). Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources*." [26 CFR § 1.861-8(f)(3)(ii)]

The above admission, which is buried in the middle of the section, shows that the general language of Section 861 is about income from "specific sources." This is akin to the older regulations saying that the types of domestic income listed in the statute are taxable for those engaged in *certain* types of commerce (i.e., foreigners doing business in the U.S. and Americans doing business in federal possessions).

The sentence quoted above says nothing about what those "specific sources" might be, or even where to find that out, but a text search for "specific sources" brings up only three other places where that term is used—all of them in Section 1.861-8, and all quoted from below. The first paragraph of Section 1.861-8—the primary section for determining taxable domestic income—includes this:

"*The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(l) of this section for a list and description of operative sections*." [26 CFR § 1.861-8(a)(1)]

So the section for determining taxable domestic income applies to income from those activities described in the "operative sections" throughout Subchapter N (shown above), which are all listed in one place in the regulations at 1.861-8(f)(1) ("paragraph (f)(l)"). The same regulation, a little further down, confirms this again:

"[T]*he term 'statutory grouping of gross income' or 'statutory grouping' means the gross income from a specific source or activity which must first be determined in order to arrive at 'taxable income' from which specific source or activity under an operative section. (See paragraph (f)(l) of this section.)*" [26 CFR § 1.861-8(a)(4)]

This confirms the definitions given above, and again shows that to have "taxable income" under this section, one must be engaged in one or more of those certain types of commerce, or "specific sources and activities," described in the operative sections (listed in 1.861-8(f)(1)).

Recall here the former legislative draftsman for the U.S. Treasury Department saying that the federal "income tax" is not actually a tax on income *per se*, but is an excise tax upon "*certain activities and privileges*." That statement correlates perfectly with the fact that the section for determining one's "*taxable income from sources within the United States*" says that it is about income from "*specific sources or activities*" (all of which relate to international trade).

Below is the final place where "specific sources" are mentioned, in "paragraph (f)(l)" itself.

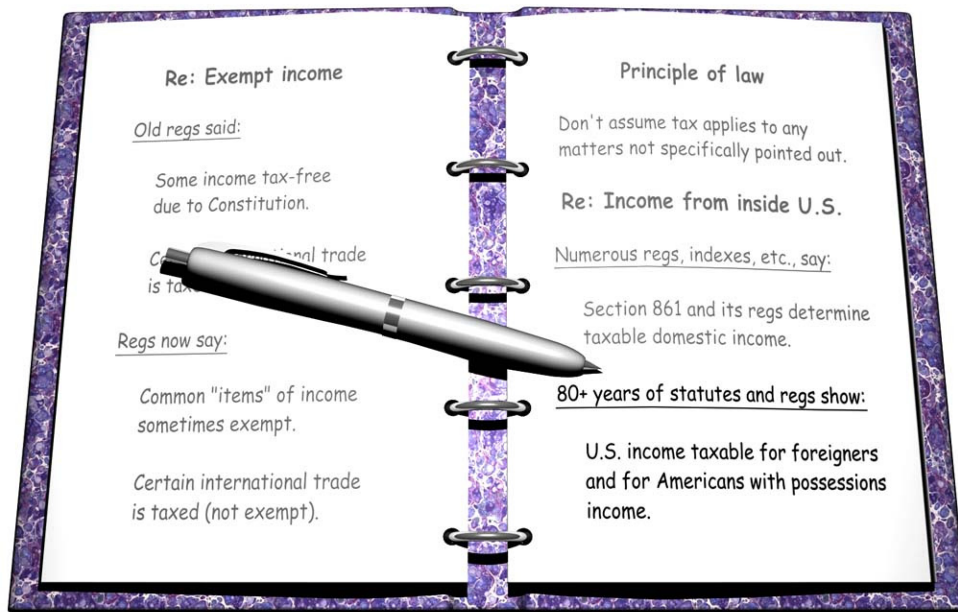
"*(1) Operative sections. The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.*
(i) Overall limitation to the foreign tax credit. Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2)...Accordingly, in this case, the statutory grouping is foreign source income..."
(ii) [Reserved] [This item was most likely intended to refer to section 911, regarding foreign earned income, as section 1.911-6 of the regulations refers to section 911 as an "operative section," and section 911 is not included anywhere else on the list.]
(iii) DISC and FSC taxable income. Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC...
(iv) Effectively connected taxable income. Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1)...
(v) Foreign base company income. Section 954 defines the term 'foreign base company income' with respect to controlled foreign corporations...
(vi) Other operative sections. The rules provided in this section also apply in determining--
(A) The amount of foreign source items of tax preference under section 58 (g)...
(B) The amount of foreign mineral income under section 901(e);
(C) [Reserved]
(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;
(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;
(F) The exclusion for income from Puerto Rico...
(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;
(H) The income derived from Guam...
(I) The special deduction granted to China Trade Act corporations under section 941;
(J) The amount of certain U.S. source income excluded from the subpart F income of a controlled foreign corporation under section 952(b);
(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);
(L) The international boycott factor and the specifically attributable taxes and income under section 999; and
(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936..." [26 CFR § 1.861-8(f)(1)]

Note that the list still includes nonresident aliens, foreign corporations, and citizens "*entitled to the benefits of section 931*"—the exact same activities described in many decades of equivalent statutes and regulations. (See Appendix E for the sections dealing with federal possessions: Section 262 from 1925, and 26 CFR § 1.931-1 of the 2004 regulations.)

(Of note, the regulation as shown above is how it appeared up until 2005. In recent years various sections of the tax code dealing with matters involving federal possessions, including Section 931, have been repealed or amended, and as a result, items (E), (F) and (H) were recently removed from the list in 1.861-8(f)(1).)

In addition to the activities which have been mentioned in over eighty years of statutory and regulatory predecessors, the above list also includes specific rules regarding individual federal possessions, other particular rules about certain foreign income, and the newer rules about DISCs (Domestic International Sales Corporations) and FSCs (Foreign Sales Corporations). But all the matters listed still involve international or foreign trade. Subsection 1.861-8(g) then gives many examples of how to use 1.861-8 to determine one's taxable income, and says that the "operative section" for each example, except as otherwise provided, is the section about foreign tax credits.

So the actual legal scope and application of this part of the law has not changed for over eighty years. The current regulations still show that U.S.-source income is taxable only for those engaged in certain *international* trade, though the sheer size and complexity of the current Section 1.861-8 seems designed to prevent the reader from easily understanding that. A reading of the entire section conveys the impression, not of the authors trying to make things clear and understandable, but of the regulation-writers trying to *confuse* the reader, using unnecessarily involved terminology and indirect and evasive language, while conspicuously failing to state in plain, simple terms the bottom line: an American with only domestic income <u>does not have taxable income from sources within the United States</u>, and therefore <u>does not owe the tax</u>.



Relocating the Truth

While the current law books do tell the literal truth about the very limited nature of the federal income tax, the way in which they do so is fundamentally different from the way they did it prior to 1954. Back then, one needed to look no further than the regulations generally defining "gross income" to learn that some income is not subject to the tax because of the Constitution itself, and that income from certain international trade (mainly the foreign income of Americans and U.S. income of foreigners) is taxable.

Back then one could also find the truth in the statutes and regulations specifically dealing with income from *inside* the U.S., which said that such income is taxable for foreigners, and for certain Americans with possessions income—which exactly matches and reinforces what the regs generally defining "gross income" said at the time. After 1954, however, any hint of the truth was completely removed from the regulations generally defining "gross income." Instead, a "legalese" trick was employed.

It is quite common for one section of law to use a certain term, while a different section defines the legal meaning of the term, often in a way very different from the way the term is used in common speech. For example, in another part of the Title 26 statutes (in an area unrelated to income taxes), one section says that the Secretary of the Treasury "*shall maintain a central registry of all firearms in the United States which are not in the possession or under the control of the United States*"[33]. Several sections away, however, the term "firearm" is defined (for purposes of that law) in a way which *excludes* the vast majority of shotguns, rifles and handguns, but includes poison gas, silencers and land mines[34]. Obviously that legal definition is drastically different from the common usage of the term "firearm," and as a result, the scope of that law is far more limited than the section read out of context would seem to indicate.

After 1954, a similar scenario existed in the federal income tax laws. Section 61 generally defines "gross income" to mean "*all income from whatever source derived*"—a definition which has often been erroneously cited as proof that all income is taxable. However, the regulations many hundreds of pages away say that Section 861 and following (and related regs) "*determine the sources of income for purposes of the income tax*"[35]. But if the reader is not aware of the fact that certain sections define what is meant by a "source of income," he will most likely misunderstand Section 61 to mean that all income is taxable, regardless of where it comes from.

But what, according to Section 861 and related sections, are the "*sources of income for purposes of the income tax*"?

> "***Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources.***" [26 CFR § 1.861-8(f)(3)(ii)]

[33] 26 USC § 5841
[34] 26 USC § 5845
[35] 26 CFR § 1.861-1

And what those "specific sources" are is shown above, in the quote from 1.861-8(f)(1). Suspiciously, those specific sources—the types of commerce to which the tax applies—are now listed only in the middle of an enormous, convoluted section of regs, under the unobtrusive heading "*Miscellaneous matters*," instead of in the first paragraph in an early, obviously relevant section called "*What included in gross income*" (and also in the regs dealing specifically with income from inside the U.S.) as was the case with the pre-1954 regulations.

Other Cover-ups

Over the years there have been several other changes to the law books which may also have been designed to conceal the truth about the very limited nature of the federal income tax. Such changes include the following:

1) In 1988, in some printings of the tax code (e.g., USC and USCA), the title of Part I of Subchapter N (which begins with Section 861) was changed from "*Determination of Sources of Income*" to "*Source Rules and Other General Rules Relating to Foreign Income*." In the USCS printing of the code, however, which more accurately reflects the underlying law (the "Statutes at Large"), the title did not change. Nor did the title of the related regulations, which still appears as "*Determination of Sources of Income*."

Because tables of contents and titles of sections do not affect the legal meaning of the text of the law[36], and because the *text* of Section 861 did not change, there was no legal significance to the changing of the title, but it did have a different kind of effect. By changing the title in a way which, read one way, implies that only those with foreign income should be looking at that part of the law, the average American would be deterred from ever looking there. In contrast, note how obviously the table of contents *prior* to the change led the reader straight to Section 861.

Subtitle A - "*Income taxes*"
Chapter 1 - "*Normal taxes and surtaxes*"
Subchapter N - "*Tax based on income from sources within or without the United States*"
Part I - "*Determination of sources of income*"
Section 861 - "*Income from sources within the United States*"
861(a) - "*Gross income from sources within United States*"
861(b) - "*Taxable income from sources within United States*"

In addition, up until 1977, the regulations related to 861(b) of the statutes were entitled "*Computation of taxable income from sources within the United States*"—an obvious place to look to determine one's taxable domestic income. After 1977, however, the title was expanded to read, "*Computation of taxable income from sources within the United States and from other sources and activities*." Like the new title of Part I (Subchapter N), that title has been interpreted by some to mean that only those who have both domestic *and* foreign income should be referring to that section. The *text* of the statutes and regulations (which is all that legally matters) gives no support for such a claim, but that would hardly matter, if the changes had the effect of dissuading the average reader from looking at those sections at all, thereby making it extremely unlikely that he would discover that purely domestic income is not subject to the tax.

[36] 26 USC § 7806(b)

2) The Paperwork Reduction Act of 1980 requires that every form used by the federal government to collect information from the public be approved by the Office of Management and Budget (OMB). The regulations at 26 CFR § 602.101 contain a table listing the OMB-approved forms for each section of regulations. Section 1 of the tax code imposes the tax on the "taxable income" of individuals, and the related regulations are found in Section 1.1-1 (titled "*Income tax on individuals*"). Up until 1995, the first line in the table in Section 602.101 identified Form 2555, "*Foreign Earned Income*," as the only approved form under Section 1.1-1. In 1995, after various "tax resistance" groups had become aware of that fact, that entry was removed from the list, in order to avoid "confusion" (according to the Treasury Department). At present no forms are listed as being approved for use related to Section 1.1-1. (The process of applying for and receiving OMB approval for a form makes the possibility of an error extremely remote. The Department of the Treasury *requested* that the form relating to *foreign* earned income—and no other form—be approved for Section 1.1-1, and the Office of Management and Budget approved it. When the entry drew too much attention, however, it was removed.)

3) After 2001, all of the editorially-supplied cross-references, including the one under Section 61 specifically pointing to Section 861 regarding "*Income from sources within the United States*," were removed from the USC and USCA printings of the tax code. (The USCS printing, however, still includes the cross-references.) Because *all* such cross-references were removed from the USC version of the Code, not just the one pointing from 61 to 861, there may have been some motivation for the change other than an intent to deceive. However, for such cross-references to be removed just a few years after thousands of Americans began looking up that particular cross-reference under 61, after those cross-references had been in place for almost *seventy years* (in both the pre- and post-1954 Codes), is more than a little suspicious.

Hints and Clues

In addition to what is shown above, many other miscellaneous bits and pieces of evidence in the law books reinforce the fact that only income from certain international trade was ever subject to the federal income tax. Taken individually, some would appear as little more than strange curiosities; when taken together, on the other hand, they show that the authors of the federal income tax statutes and regulations were well aware of the very limited nature of the tax. A few such hints and clues are described below.

1) As mentioned above, Form 2555, "*Foreign Earned Income*," was the only form ever approved under the Paperwork Reduction Act to be filed in relation to Section 1.1-1 of the regulations (which is titled "*Income tax on individuals*"). Similarly, the only approved form related to Sections 1.861-2 and 1.861-3 (which deal with interest and dividends from within the U.S.) is Form 1040NR, "*U.S. Nonresident Alien Income Tax Return*," and the only form approved in relation to Section 1.861-8 itself is Form 1120-F, "*U.S. Income Tax Return of a Foreign Corporation*."

2) Each federal regulation, when published, cites the legal authority under which it was promulgated. Section 1.861-8 cites the general rule-making authority delegated by 26 USC § 7805, as well as 26 USC § 882—the "operative section" related to *foreign* corporations doing business in the U.S. (This matches the fact that the form approved for use with 1.861-8 is for foreign corporations.) Likewise, the equivalent "temporary" regulations at Section 1.861-8T cite Treasury Decision 8228, which states that the section gives "*foreign tax credit rules and certain other international tax provisions*," again showing that the sections for determining taxable domestic income (1.861-8 and 1.861-8T) are all about international trade.

3) Several sections of the tax code, including Section 1 (which imposes the tax on individuals), as well as Sections 59, 66 and 469, refer to Section 911(d)(2) of the Code regarding the definition of the term "earned income." There is nothing unusual about the definition itself, which says that "*The term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered*" (with a few exceptions). What is curious is the *location* of that definition:

Subchapter N - "*Tax based on income from sources within or without the United States*"
Part III - "*Income from sources without the United States*"
Subpart B - "*Earned income of citizens or residents of United States*"
Section 911 - "*Citizens or residents of the United States living abroad*"

Again, compare this to the fact that the only form approved for use with the regs under Section 1 is about "foreign earned income," meaning income earned *outside* the United States.

4) Along the same lines, if one looks in the indexes of the United States Code under "Income tax" and finds the entries under "citizens," only things such as "*living abroad*" and "*about to depart from U.S.*" are found—again implying that U.S. citizens are taxed primarily on income they receive for work done *outside* the country.

5) For many years one particular hint about the true nature of the federal income tax has been hiding right under the noses of many millions of Americans. The infamous Form 1040, the income tax return used by many millions of Americans, has an instruction booklet that accompanies it. The form itself is divided into several parts (e.g., personal information, exemptions, income, etc.), and for each part of the form, the instruction booklet gives some general information, and then gives line-by-line instructions on how to fill out the form. Under the part of the form about "income," the instruction booklet begins by saying this:

"*Foreign-Source Income*
You must report unearned income, such as interest, dividends, and pensions, from sources outside the United States unless exempt by law or a tax treaty. You must also report earned income, such as wages and tips, from sources outside the United States.
If you worked abroad, you may be able to exclude part or all of your earned income. For details, see Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, and Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.
Community Property States...
Rounding Off to Whole Dollars..."

That is all the booklet says about the general topic of "income." It then gives specific directions explaining which different items of income to report on which line. What is shown above is the *only* thing in the booklet mentioning the type of *commerce* from which the income derives; the rest is about "items" of *income*.

Though such forms are not legally binding, this one mirrors the method used in many decades of regulations: telling U.S. citizens that they *must* report any foreign-source income they receive, without specifically saying whether the domestic income of the average American is also subject to the tax. The effectiveness of such a lie-by-omission is demonstrated by the fact that the many *millions* of Americans who receive that booklet and read it simply assume that what it *means* is that citizens must report their foreign income *in addition to* their domestic income, though that is *not* what the booklet says, nor is that how one is meant to interpret the law (i.e., to assume it applies to matters "*not specifically pointed out*").

6) Something very similar exists in IRS Publication 525, which is entitled "*Taxable and Nontaxable Income*." Right up front the publication says this:

"*Reminders*
Foreign Income
If you are a U.S. citizen or resident alien, you must report income from outside the United States (foreign income) unless it is exempt by U.S. law."

The publication then goes on to discuss (in its own words) "*many kinds of income and explains whether they are taxable or nontaxable*." Again, the quote above is the only place where the publication addresses the issue of commerce; the rest deals with specific items of income. And again, most readers would assume that income they receive from *domestic* commerce must also be taxable, though nowhere does the publication actually say that.

7) There are some places in the tax code where, if the reader assumes that most people owe the tax, he runs into a logical contradiction. For example, one section deals with income from selling certain kinds of stocks. That section says that if such income "*is determined to be derived from sources within the United States*," then such income is to be considered "*fixed or determinable annual or periodical gains, profits, and income within the meaning of section 871(a) or section 881(a), as the case may be*"[37]. But sections 871 and 881, which are located in Part II of Subchapter N, are clearly and exclusively about nonresident aliens and foreign corporations. If a U.S. citizen with income from that kind of stock sales looks at the law (while assuming that such income is taxable for him) he runs into a logical brick wall, because he is told only that such income shall be considered taxable under the rules about *foreigners*—rules which obviously do not apply to him.

[37] 26 USC § 306(f)

8) A similar conundrum occurs when conventional wisdom comes up against the rules about "community income" (joint income received by married couples). If two married people are living apart, and one or both of them receives such "community income," the tax code says that such income "*shall be treated in accordance with the rules provided by section 879(a)*". Once again, average Americans trying to make sense of the rules (while assuming their income is taxable) hit an impasse. Why? Because Section 879(a) is about "*Tax treatment of certain community income in the case of nonresident alien individuals*," and applies only to a couple, one or both of whom are nonresident aliens. Again, the section cannot be used by average Americans, who are left hanging when they read the section. If, on the other hand, the reader is aware that purely domestic income is not taxable for U.S. citizens (but is taxable for foreigners), then the law makes perfect sense.

9) In 1991 (before the section was removed), the Internal Revenue Manual—the IRS's own internal manual—said this:

"*The Criminal Investigation Division* [of the IRS] *enforces the criminal statutes applicable to income, estate, gift, employment, and excise tax laws... involving United States citizens residing in foreign countries and nonresident aliens subject to Federal income tax filing requirements...*" [Internal Revenue Manual, Section 1132.55 (1991)]

What about citizens working in the 50 states? Why is there no mention of them?

10) The regulations at 26 CFR § 601.101 generally describe the functions of the Internal Revenue Service. In that section, the only specific mention of who or what is subject to taxes administered by the IRS reads as follows:

"*The Director, Foreign Operations District, administers the internal revenue laws applicable to taxpayers residing or doing business abroad, foreign taxpayers deriving income from sources within the United States, and taxpayers who are required to withhold tax on certain payments to nonresident aliens and foreign corporations...*" [26 CFR § 601.101(a)]

11) The official decisions and rulings by the IRS are published regularly in the "Internal Revenue Bulletin." Year after year, all the way from 1913 to the present day, those bulletins reinforce the fact that the federal income tax is (and always has been) a tax upon "commerce with foreign nations." For example, the Cumulative Bulletin covering the years 1957 through 1960 contains *nine* listings of rulings and decisions regarding "citizens," every one of which is about citizens who are *outside* the United States. Likewise, under the category of "Income—Source," that same bulletin contains thirty-five entries, all but one of which are obviously about *international* trade. The one exception is about Treasury Decision 6258, which (as shown above) says that Sections 861 and following, and related regs, give the rules for the "*determination of gross income and taxable income derived from sources within and without the United States*." (And those rules show only income from international commerce to be taxed.)

Year after year after year, whenever the issue of commerce (or "sources" of income) is addressed in the law books, what is discussed is always certain *foreign* income of Americans, the U.S. income of *foreigners*, and matters involving federal *possessions*. What is *never* specifically discussed is a U.S. citizen who lives and works exclusively within the 50 states.

As illustrated above, what is *not* stated in legal documents can be just as important as what *is* stated. Consider all the documents referred to above in which the average American earning a living in the U.S. *could* have been mentioned, *but was not*. What are the chances that by sheer coincidence, *over eighty years'* worth of legal documents *accidentally* failed to ever specifically state that the U.S.-source income of all U.S. citizens is taxable? The very idea is preposterous, but the only alternative explanation is something many Americans may not want to consider: that the federal government is collecting well over a *trillion* dollars every year from people who *do not owe it*, and that this is the result of an intentional deception planned and carried out by some in the federal government.

The Other Side

For several years now, some agents of the federal government have continued to loudly declare that most Americans owe federal income taxes, backing that assertion with little more than "because we say so." Rather than giving any substantive response to the evidence shown above, the IRS and various lower-court judges have simply harped on the "from whatever source derived" language in the general definition of "gross income," to the exclusion of just about everything else (which is a mistake for several reasons, as shown above), asserted (without legal support) that most people should not be looking at Section 861 and its regulations, and proclaimed that any view to the contrary is "frivolous."

Within or Without

Other than the general definition of "gross income," about the only other citation used to try to rebut the issue shown above comes from Section 1.1-1 of the regulations, which says that citizens are liable to the taxes imposed by the code whether their income is "*from sources <u>within or without</u> the United States*." However, as Section 1.1-1 itself admits, the tax imposed by the Code is only upon *taxable* income, not all income. Of course, that one statement from the regs could not negate all the rules for determining what constitutes *taxable* income, nor does it claim to. And yes, when those regulations were written, it was possible for citizens to have taxable income from *inside* the United States, <u>if</u> they also did business in federal *possessions*. And yes, every citizen who has *taxable* income, whether from inside or outside the United States, owes the tax. So, how does a citizen determine whether his domestic and/or foreign income is <u>taxable</u>?

Subchapter N of the tax code (Section 861 and following) is about "*Tax based on income from sources <u>within or without</u> the United States*." In addition, the index of the regulations, as cited before, tells one to go to the regs under 861 regarding "*Income from sources <u>inside or outside</u> U.S.*" And, in case any doubt might remain, the regulations also say this:

"*(c) Determination of taxable income. The taxpayer's taxable income from sources <u>within or without</u> the United States <u>will be determined</u> under the rules of <u>Secs. 1.861-8</u>* [and following]."
[26 CFR § 1.863-1(c)]

So yes, citizens are taxed on any *taxable* income they receive, whether "*from sources within or without the United States*," and in order to *determine* their taxable income (foreign or domestic) they must refer to Section 861 and following, and related regulations. And, as shown above, those sections show income to be taxable only when it derives from certain types of *international* trade.

Smoke and Mirrors

Ironically, the mantra of most of the status quo tax professionals, inside and outside government, has been, "Those sections [861, etc.] don't apply to you." In one sense, that is quite true: those sections are all about international commerce, not about the income of the average American. But the conventional wisdom adherents then apply backwards logic to justify their foregone conclusions. If the sections specifically designated for determining taxable domestic income "don't apply" to your income, the proper conclusion to draw is not that you should ignore those sections, but that your domestic income is not taxable.

As an analogy, consider the example discussed previously, where one section of law imposes requirements applicable to "all firearms," while a nearby section legally defines the term "firearm" (for purposes of that law) in an extremely limited way, *excluding* most handguns, rifles and shotguns. If you own a conventional shotgun, and the legal definition of "firearm" does not apply to your gun, that obviously does not mean you should ignore the definition; it means that that entire law imposes no requirement upon you. Likewise, if you receive no taxable domestic income and no taxable foreign income—as defined by law—then the federal income tax laws impose no legal obligation upon you whatsoever.

Another popular retort to the issue addressed herein is the claim that it takes something "out of context," yet the status quo proponents can never cite any such "context" which would change the meaning of what the words in the law books (such as those quoted above) say. To be blunt, the "out of context" accusation is nothing more than a cheap ploy designed to defend the supposed expertise of "the professionals" in the eyes of the public, by implying that only the "experts" could possibly understand the law or know everything it contains, and that we "common folk" have no business trying to read and understand the law for ourselves.

Still others try to dismiss an opposing view by labeling it as just one person's "interpretation"—as if mere evidence and logic cannot make one opinion more valid than another. In truth, little if any "interpretation" is involved. The only time it is even *possible* to "interpret" something is when one set of words could literally have more than one meaning. (For example, "I saw wood" could mean "I have seen wood" or "I cut wood with a saw.") Otherwise, the words simply mean what they say, and there is nothing to "interpret." A review of the various citations above will show that few if any of them can have more than one meaning, so no "interpretation" is required. (It is the conclusions of the so-called experts that don't match what the law actually says. As a result, their opinions do not even qualify as "interpretations"; they are instead merely baseless assertions.)

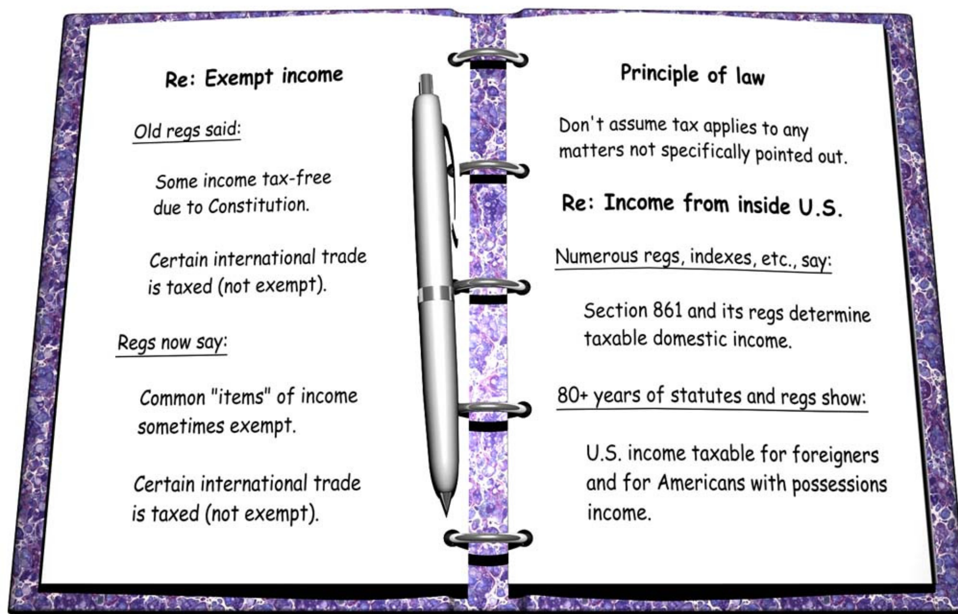
Furthermore, keep in mind that if there are two ways to read a given section of tax law, the Supreme Court has often said (in Gould v. Gould and many subsequent cases) that in case of doubt, tax laws are to be construed (interpreted) in favor of the citizen, *not* in favor of the government.

Some particularly unscrupulous naysayers (mostly in government) also routinely mischaracterize the issue as a "tax protestor" issue, when it is nothing of the kind. As can be seen above, the issue is not at all about objecting to the tax. What is being "protested" is not the law itself—which imposes a limited, perfectly Constitutional tax—but the misrepresentation and misapplication of the law, resulting in the deprivation of well over a trillion dollars a year from people who, by law, did not owe a dime. Put another way, this is not about people not wanting to pay "their taxes"; it is about people not wanting to be forced to pay something that is not, and never was, "their taxes," but which is instead an excise tax only upon certain activities relating to *international* trade).

As an aside, any contrary theorizing about what Congress could Constitutionally tax (including such theorizing on the part of federal judges) is obviously far less important than what the law shows they *did* tax (i.e., international trade). In other words, one can argue until he is blue in the face that Congress does have the Constitutional authority to tax the income of all Americans, but if the law shows that Congress did not do so (which is exactly what it shows), that debate becomes purely academic.

All the Pieces Fit

Despite the complexity of the tax laws, in the end the issue is pretty simple. Let's review our clue book one last time. Remember, these basic clues were all given to us by the government's own official law books. Go over them one by one, and then ask yourself: How many possible explanations there are which can account for all of these clues.



In short, there is one, and only one, way that all the pieces fit. There is only one conclusion, albeit a fairly disturbing one, which logically follows from the evidence. And that conclusion is this:

The federal "income tax" is and has always been a tax only upon certain *international* trade, and therefore the vast majority of Americans have never legally owed a dime in federal income taxes, but have been deceived into believing otherwise.

Mental Inertia and Censorship

Anytime a large number of people—in this case hundreds of millions—hold a particular belief, it takes a lot to change that belief. There is a sort of "mental inertia" that keeps most people from ever questioning things they have always accepted as obviously true. "Everyone knows" that most Americans owe federal income taxes, but that belief comes, not from all of those people examining the law, but from all of those people hearing other people asserting that it is so. All too often the human mind accepts something as the gospel truth based on nothing more than "Everyone says it, so it must be true."

But truth is not a democracy. The popularity of an idea often has no relevance to whether or not it is true. History is full of examples of popular misconceptions lasting for hundreds or even thousands of years, based solely upon the phenomenon of "common knowledge." And throughout history, when the occasional nonconformist has stepped forward to challenge the "conventional wisdom," he has, more often than not, been ridiculed, insulted, and sometimes tortured or killed. So it is that long-held false beliefs have a tendency to survive a very long time, even when they fly in the face of all evidence and logic.

Furthermore, if some misconception supplies some people with power, those people will often go to great lengths to defend the lie and destroy the truth. Few people want to have unpopular beliefs, and even fewer want to express a belief that will bring down the wrath of a powerful "authority" upon their heads. The concept of the "heretic," who is demonized, ostracized, condemned and punished for disputing the gospel according to the powers that be, is certainly nothing new. Not many people are willing to say something that sounds ridiculous to most people, especially if doing so will put them in harm's way in the process. As a result, ignorance has tremendous staying power.

Since the late 1990s, when the legal issue addressed above first began to draw significant public attention, some in government (particularly those working for the IRS and the U.S. "Justice" Department) have waged an all-out attack on those who have been vocal about the issue—obtaining court orders to forcibly shut down web sites, imposing large fines upon those tax professionals who have *agreed* with the issue and told their clients about it, and publicly demonizing and mischaracterizing as "tax protestors," "tax cheats," and "scam artists" those who dare to openly and publicly question conventional wisdom. In addition, the government has shown only contempt and hostility towards the many thousands of Americans who have merely asked questions about the above issue in an effort to better understand the law.

The government's ongoing thuggery, and suspicious inability or unwillingness to have a rational discussion about what its own law books say, is almost as damning as the evidence in the law itself. If there were answers, if there was some explanation for all of the citations above which could still preserve the "conventional wisdom" about the tax (i.e., that most Americans owe it), it would obviously have been in the government's best interest to give those answers and to provide that explanation. But it has not done so.

One who is not sure of what is true will often hesitate to voice his opinion. However, no one should feel shame or fear when simply asking reasonable questions. A nation in which the people dare not do even that is not "free" by any rational definition. So, for those Americans who still believe that they have the right to ask their government questions about the law, the following list of questions is included. Based upon the answers he receives to such questions, whether from a private tax preparer or a government official, the reader can judge for himself what is true and what is not. What to do about his conclusion is up to him.

<u>Questions Regarding Determining Taxable Income</u>

1) Should I, an American citizen living in the United States and deriving all of my income from within the 50 states, use the rules found in 26 USC § 861(b), and the related regulations beginning at 26 CFR § 1.861-8, to determine my taxable domestic income?

2) If some individuals—including myself—should *not* use those sections for determining their taxable domestic income, please show me where the regulations say who should or should not use those sections for that.

<u>Reason for first two questions:</u> The regulations under 26 USC § 861(b) (26 CFR § 1.861-8 and following) begin by stating that Sections 861(b) and 863(a) state in general terms "*how to determine taxable income of a taxpayer from sources within the United States*" after gross income from the U.S. has been determined. (The regulations then say that Sections 862(b) and 863(a) describe how to determine taxable income from *outside* of the U.S.) Section 1.861-1(a)(1) of the regulations confirms that "*taxable income from sources within the United States*" is to be determined in accordance with the rules of 26 USC § 861(b) and 26 CFR § 1.861-8. (See also 26 CFR §§ 1.862-1(b), 1.863-(c).)

3) If a U.S. citizen lives and works exclusively within the 50 states, and receives all of his income from within the 50 states, do 26 USC § 861(b) and 26 CFR § 1.861-8 show such income to be taxable?

<u>Reason for question:</u> Section 217 of the Revenue Act of 1921, statutory predecessor of 26 USC § 861 and following, stated that income from within the U.S. was taxable for foreigners and for U.S. citizens and corporations deriving most of their income from federal possessions (but did *not* say the same about the domestic income of most Americans). The regulations under the equivalent section of the 1939 Code (e.g. §§ 29.119-1, 29.119-2, 29.119-9, 29.119-10 (1945)) showed the same thing. The current regulations at 1.861-8 still show income to be taxable only when derived from certain "*specific sources and activities*," which, concerning *domestic* income, still relate only to foreigners and certain Americans receiving income from federal possessions (26 CFR §§ 1.861-8(a)(1), 1.861-8(a)(4), 1.861-8(f)(1)).

4) Should one refer to 26 CFR § 1.861-8T(d)(2) to determine whether the "items" of income he receives (such as compensation, interest, rents, dividends, etc.) are excluded for federal income tax purposes?

<u>Reason for question:</u> The regulations (26 CFR § 1.861-8(a)(3)) state that a "*class of gross income*" consists of the "items" of income listed in 26 USC § 61 (e.g. compensation, interest, etc.). The regulations (26 CFR §§ 1.861-8(b)(1)) then direct the reader to "paragraph (d)(2)" of the section, which provides that such "*classes of gross income*" may include some income which is *excluded* for federal income tax purposes.

5) What is the purpose of the list of non-exempt types of income found in 26 CFR § 1.861-8T(d)(2)(iii), and why is the income of the average American *not* on that list?

<u>Reason for question:</u> After defining "*exempt income*" to mean income which is exempt, eliminated, or excluded for federal income tax purposes (26 CFR § 1.861-8T(d)(2)(ii)), the regulations give a list of types of income which are *not* exempt (i.e. which *are* subject to tax), which includes the domestic income of foreigners, certain foreign income of Americans, income of certain possessions corporations, and income of international and foreign sales corporations, but which does *not* include the domestic income of the average American (26 CFR § 1.861-8T(d)(2)(iii)).

6) What types of income (if any) are *not* exempted from taxation by any *statute*, but are nonetheless "*excluded by law*" (not subject to the federal income tax) because they are, under the Constitution, not taxable by the federal government?

<u>Reason for question:</u> Older income tax regulations defining "gross income" and "net income" said that income is not subject to the tax if exempted by either statute or "*fundamental law*" (§ 39.21-1 (1956)), and said that in addition to those types of income exempted by *statute*, other types of income were also exempt because they were, "*under the Constitution, not taxable by the Federal Government*" (§ 39.22(b)-1 (1956)). (See also 26 CFR § 1.312-6(b).).

its stockholders, or both, are in control of a transferee corporation, it is not necessary that the stock be acquired on or after January 1, 1951. Thus, if Corporation F on June 1, 1950, owns 70 percent of the voting stock of Corporation G, and, thereafter, on January 2, 1952, Corporation F acquires an additional 10 percent of such stock, control within the meaning of section 15(c) is acquired by Corporation F on January 2, 1952.

(d) **Nature of transfer.** A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 112(g), is within the scope of section 15(c), except that section 15 (c) does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 15(c), irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(e) **Purpose of transfer.** In determining, for the purpose of section 15 (c), whether the securing of the exemption from surtax or the minimum excess profits credit constituted "a major purpose" of the transfer, all circumstances relevant to the transfer shall be considered. For disallowance of the surtax exemption and minimum excess profits credit under section 15(c), it is not necessary that the obtaining of either such credit or exemption or both have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the minimum excess profits credit may constitute "a major purpose" of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 112(g). The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not "a major purpose" of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

(f) **Taxable years to which applicable.** Section 15(c) and this section do not apply to any taxable year with respect to which the excess profits tax imposed by subchapter ll of chapter 1 of the Internal Revenue Code is not in effect. For treatment of taxable years beginning before April 1, 1954, and ending after March 31, 1954, see § 39.-108—2. For computation of the excess profits tax for certain fiscal years, see § 40.430-2(b) (2) and (c) of Regulations 130 (Part 40 of this chapter).

COMPUTATION OF NET INCOME

§ 39.21 [Comprises Code section 21, see 26 U.S.C.A. § 21] § 39.21—1 Meaning of net income

(a) The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21. (See section 24 (a) (5).) In the computation of the tax various classes of income must be considered:

(1) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived

from the sale or other disposition of capital assets. Cash receipts alone do not always accurately reflect income, for the Internal Revenue Code recognizes as income determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. (See sections 22, 23, 24, and 117.)

(2) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(3) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

(4) Net income less certain credits. (See sections 25, 26, 27, and 28.)

(b) The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications, statutory net in-come is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. (See section 41.)

(c) The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. (See sections 23, 24, 102, 118, 121, 122, 203, 204, 207, 232, and 336, and sections 500 to 511, inclusive.)

§ 39.22 (a) [Comprises Code section 22 (a), see 26 U.S.C.A. § 22 (a)]

§ 39.22 (a)—1 What included in gross income

(a) Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. See sections 22(b) and 116. In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

(b) If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see § 39.22 (a)-8.

of which was deductible by the patron under section 23, shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents

(a) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the co-operative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by § 39.101 (12)–4 (a) (2).

(b) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under § 39.101–4(a).

(c) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in subdivision (a) of this subparagraph, or from amounts retained as "reasonable reserves" under § 39.101 (12)-4 (a), referred to in subdivision (b) of this subparagraph. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

(2) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services the cost of which was not deductible by the patron under section 23, are not includible in the computation of the gross income of such patron; however, in the case of such amounts which are allocated with respect to capital assets (as defined in section 117(a) (1)) or property used in the trade or business within the meaning of section 117(j), shall, to-the extent set forth in subdivisions (i), (ii), and (iii) of subparagraph (1) of this paragraph, be taken into account in determining under section 113 the cost or other basis of the assets or property purchased for the patron.

§ 39.22 (b) [Comprises Code section 22 (b), see 26 U.S.C.A. § 22 (b)]

§ 39.22 (b)—1 Exemptions; exclusions from gross income

Certain items of income specified in section 22(b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items may be excluded from gross income except (a) those items of income which are, under the Constitution, not taxable by the Federal Government; (b) those items of income which are exempt from tax on income under the provisions of any act of Congress still in effect; and (c) the income excluded under the provisions of the Internal Revenue Code (see particularly section 116). Since the tax is imposed on net income, the exemption referred to above is not to be confused with the deductions allowed by section 23 and other provisions of the Internal Revenue Code to be made from gross income in computing net income. As to other items not to be included in gross income, see sections 22(k), 112, 119, 127 (c), 165, and 171 and Supplements G, H, I, and J (sections 201 to 252, inclusive). Section 607(h) of the Merchant Marine Act, 1936, as amended, [46 U.S.C.A. § 1177(h)] reads as follows:

(h) The earnings of any contractor receiving an operating-differential subsidy under authority of this act, which are deposited in the contrac-

account in the year such income is ultimately included in gross income.

(ii) *Exempt income and exempt asset defined*—(A) *In general*. For purposes of this section, the term *exempt income* means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term *exempt asset* means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) *Certain stock and dividends*. The term ''exempt income'' includes the portion of the dividends that are deductible under—

(*1*) Section 243(a) (1) or (2) (relating to the dividends received deduction),

(*2*) Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder's share of such dividends. See §1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in §1.861–10T(c), and in the apportionment of other expenses under the consolidation rules set forth in §1.861–14T.

(iii) *Income that is not considered tax exempt*. The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of §1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) *Prior years*. For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by §1.861–13T, see §1.861–8(d)(2) (Revised as of April 1, 1986).

(e) *Allocation and apportionment of certain deductions*.

(1) [Reserved]. For further guidance, see §1.861–8(e)(1).

(2) *Interest*. The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§1.861–9T through §1.861–13T.

(3) through (11) [Reserved]. For further guidance, see §1.861–8(e)(3) through (e)(11).

(f) *Miscellaneous matters*—(1) *Operative sections*.

(i) [Reserved]

(ii) *Separate limitations to the foreign tax credit*. Section 904(d)(1) requires

(b) [Reserved]

[T.D. 8458, 57 FR 61313, Dec. 24, 1992]

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§ 1.861–1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861–2 to 1.861–7, inclusive, and § 1.863–1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.861–8 and 1.863–1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862–1 and 1.863–1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862–1 and 1.863–1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863–2 to 1.863–5, inclusive.

(4) *Exceptions.* An owner of certain aircraft or vessels first leased on or before December 28, 1980, may elect to treat income in respect of these aircraft or vessels as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9. An owner of certain aircraft, vessels, or spacecraft first leased after December 28, 1980, must treat income in respect of these craft as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861–9A.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources

within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7928, 48 FR 55845, Dec. 16, 1983]

§ 1.861–2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States. See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

(2) The term ''resident of the United States'', as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

(4) For purposes of this section, the term ''interest'' includes all amounts treated as interest under section 483, and the regulations thereunder. It also includes original issue discount, as defined in section 1232(b)(1), whether or not the underlying bond, debenture, note, certificate, or other evidence of indebtedness is a capital asset in the hands of the taxpayer within the meaning of section 1221.

(5) If interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States.

(6) In the case of interest received by a nonresident alien individual or foreign corporation this paragraph (a) applies whether or not the interest is effectively connected for the taxable year with the conduct of a trade or business in the United States by such individual or corporation.

(7) A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive a substantially identical securities from the transferee in the future in exchange for cash. A substitute interest payment shall be sourced in the same manner as the interest accruing on the transferred security for purposes of this section and § 1.862–1. See also §§ 1.864–5(b)(2)(iii), 1.871–7(b)(2), 1.881–2(b)(2) and for the character of such payments and § 1.894–1(c) for the application tax treaties to these transactions.

(b) *Interest not derived from U.S. sources.* Notwithstanding paragraph (a) of this section, interest shall be treated as income from sources without the United States to the extent provided by subparagraphs (A) through (H), of section 861(a)(1) and by the following subparagraphs of this paragraph.

(1) *Interest on bank deposits and on similar amounts.* (i) Interest paid or credited before January 1, 1977, to a

(3) In the case of an individual who dies during the taxable year, the credits allowed by subdivisions (c), (d), and (e) shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the taxable year.

NET INCOME OF NONRESIDENT ALIEN INDIVIDUALS

SEC. 217. (a) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:

(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor or domestic corporation has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable;

(2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section;

(3) Compensation for labor or personal services performed in the United States;

(4) Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located in the United States.

(b) From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a);

(2) Dividends other than those derived from sources within the United States as provided in paragraph (2) of subdivision (a);

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

(5) Gains, profits, and income from the sale of real property located without the United States.

(d) From the items of gross income specified in subdivision (c) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some items or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from sources within the country in which sold, except that gains, profits and income derived from the purchase of personal property within the United States and its sale within a possession of the United States or from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States.

(f) As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured" or "aged."

(g) (1) Except as provided in paragraph (2) a nonresident alien individual or a citizen entitled to the benefits of section 262 shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits.

(2) The benefit of the credits allowed in subdivisions (d) and (e) of section 216, and of the reduced rate of tax provided for in subdivision (b) of section 210, may, in the discretion of the Commissioner and under regulations prescribed by him with the approval of the Secretary, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

PARTNERSHIPS

SEC. 218. (a) Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the taxable year upon the basis of which the partner's net income is computed.

(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (10) of subdivision (a) of section 214 shall not be allowed.

ESTATES AND TRUSTS

SEC. 219. (a) The tax imposed by Parts I and II of this title shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) Except as otherwise provided in subdivisions (g) and (h), the tax shall be computed upon the net income of the estate or trust,

INCOME FROM SOURCES WITHIN THE POSSESSIONS OF THE UNITED STATES

SEC. 262. (a) In the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section), for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

CHINA TRADE ACT CORPORATIONS

SEC. 263. (a) For the purpose only of the tax imposed by section 230 there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922, a credit of an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 217) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by (1) persons resident in China, the United States, or possessions of the United States, and (2) individual citizens of the United States or China wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date: *Provided,* That in no case shall the amount by which the tax imposed by section 230 is diminished by reason of such credit exceed the amount of the special dividend certified under subdivision (b) of this section.

(b) Such credit shall not be allowed unless the Secretary of Commerce has certified to the Commissioner—

(1) The amount which, during the year ending on the date fixed by law for filing the return, the corporation has distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China, and owned shares of stock of the corporation;

(2) That such special dividend was in addition to all other amounts, payable or to be payable to such persons or for their benefit, by reason of their interest in the corporation; and

(3) That such distribution has been made to or for the benefit of such persons in proportion to the par value of the shares of stock of the corporation owned by each; except that if the corporation

consecutive taxable years, as provided in Q&A 16 of this section.

Q–16. Under what circumstances is the FSC or small FSC election terminated for continued failure to be a FSC?

A–16. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify under section 922 to be treated as a FSC or small FSC for each of 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically without notice to such corporation or to the Internal Revenue Service.

[T.D. 8127, 52 FR 6475, Mar. 3, 1987]

POSSESSIONS OF THE UNITED STATES

§ 1.931–1 Citizens of the United States and domestic corporations deriving income from sources within a certain possession of the United States.

(a) *Definitions.* (1) As used in section 931 and this section, the term ''possession of the United States'' includes American Samoa, Guam, Johnston Island, Midway Islands, the Panama Canal Zone, Puerto Rico, and Wake Island. However, the term does not include (i) the Virgin Islands and (ii), when used with respect to citizens of the United States, the term does not include Puerto Rico or, in the case of taxable years beginning after December 31, 1972, Guam.

(2) As used in section 931 and this section, the term ''United States'' includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) *General rule*—(1) *Qualifications.* In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(i) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(ii) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. The salary or other compensation paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 931 and this section, be deemed to be derived from sources within the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, does not represent income derived from the active conduct of a trade or business within the possession of the United States even though such citizen was actively engaged in the management of such corporation. For a determination of income from sources within the United States, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and section 931(i), and the regulations thereunder.

(2) *Relationship of sections 931 and 911.* A citizen of the United States who cannot meet the 80-percent and the 50-percent requirements of section 931 but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of earned income from sources outside the United States), provided he meets the requirements thereof. In such a case none of the provisions of section 931 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 911(b).

(3) *Meaning of ''gross income'' on joint return.* In the case of a husband and