

Part I – 1986 Code

Section 861 – Income from Sources within the United States (Also: 6662, 6663, 6702)

Rev. Rul. 2004-30

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by taking the position that United States citizens and residents of the United States are not subject to tax on their wages and other income earned or derived within the United States (“the Section 861 position”). These taxpayers rely on sections 861 through 865 of the Code and the regulations (in particular, Treasury Regulation § 1.861-8) to argue that taxes are only imposed on income derived from certain foreign-based activities. The Service also is aware that promoters, including return preparers, are advising or recommending that taxpayers take frivolous positions based on this argument. Some promoters may be marketing a package, kit, or other materials that claim to show taxpayers how they can avoid paying income taxes based on this and other meritless arguments.

This revenue ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with this scheme, that there is no authority in sections 861 through 865 that permits an individual to take the position that either the individual or the individual’s U.S.-based income is not subject to federal income tax. This argument has no merit and is frivolous. The rules of sections 861 through 865 have significance solely in determining whether income is considered from sources within the United States or without the United States, which is relevant, for example, in determining whether a U.S. citizen or resident may claim a credit for foreign taxes paid.

The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions, such as the Section 861 position. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through its Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether an individual may avoid income tax by claiming that under sections 861 through 865, United States citizens and residents are not subject to tax on wages and other income earned or derived in the United States.

FACTS

A taxpayer who is either a citizen or resident of the United States files a return excluding income received from U.S. sources, claiming that the income is not subject to tax because sections 861 through 865 purportedly provide that only certain foreign source income is subject to tax.

LAW AND ANALYSIS

Sections 861 through 865 do not limit gross income subject to United States taxation to foreign-source income. In Notice 2001-40, 2001-1 C.B. 1355, the Service advised taxpayers that it considers the Section 861 position to be a frivolous position. Courts repeatedly have rejected this and similar arguments as frivolous, and have penalized taxpayers who make these types of arguments. See, e.g., Takaba v. Commissioner, 119 T.C. 285 (2002) (concluding that “[t]he 861 argument is frivolous” and sanctioning both the taxpayer and his attorney for making such frivolous arguments); Madge v. Commissioner, T.C. Memo. 2000-370 (concluding that the argument that only foreign income is taxable is frivolous). For more information, please see Notice 2001-40. Notice 2001-40 and other information on frivolous tax positions are available on the Service website at www.irs.gov.

CIVIL AND CRIMINAL PENALTIES

In determining the correct amount of tax due, the Service will include income that taxpayers attempt to exclude based on the Section 861 position. In addition to liability for tax due plus statutory interest, individuals who claim tax benefits on their returns based on this and other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalty, which is equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a \$500 penalty under section 6702 for filing a frivolous return; and (4) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on this scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 5 years; or (2) making false statements on a return under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a \$250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or \$1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

Any position that, under sections 861 through 865, United States citizens and residents are not subject to tax on wages and other income earned or derived in the United States is frivolous. Taxpayers attempting to reduce their federal tax liability by taking frivolous positions based on this argument will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against taxpayers where appropriate, and those taxpayers also may face criminal prosecution. The Service also will determine appropriate civil penalties against persons who prepare frivolous returns or promote frivolous positions, and those persons also may face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

.DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office on (202) 622-4910 (not a toll-free call).