

Part I

Section 61.—Gross Income Defined

26 CFR § 1.61-2: Compensation for services, including fees, commissions, and similar items

(Also:)

Rev. Rul. 2007-19

PURPOSE

The Internal Revenue Service (Service) is aware that some taxpayers are attempting to reduce or eliminate their federal income tax liability by claiming that compensation received in exchange for personal services is not taxable income. These taxpayers often attempt to avoid their federal income tax liability by failing to file federal income tax returns or by failing to report all income from wages or other compensation on their federal income tax return. They often furnish Forms W-4, Employee Withholding Allowance Certificates, on which they claim excessive withholding allowances or claim complete exemption from withholding. In addition, they often claim deductions from gross income for personal, living and family expenditures in order to reduce the tax liability related to wages or other compensation.

The Service is aware that some promoters and return preparers are advising or recommending that taxpayers take these or other meritless positions. This revenue ruling emphasizes to taxpayers, promoters and return preparers that wages and other compensation received in exchange for personal services are taxable income subject to federal income tax. Any argument that such compensation is not taxable income has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. 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 the Service's Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns; computes the correct amount of tax and interest due; and determines whether civil or 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 an injunction should be sought to halt these activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether Taxpayer A may avoid federal income tax liability by maintaining that the Internal Revenue Code does not tax wages or other compensation received in exchange for personal services.

FACTS

Taxpayer A receives wages in exchange for personal services. Taxpayer A then does one or more of the following: (1) furnishes a Form W-4 to the employer on which Taxpayer A claims excessive withholding allowances or claims complete exemption from withholding; (2) fails to file a federal income tax return; (3) fails to report the wages on the federal income tax return; (4) claims a refund for any withheld income tax; or (5) claims deductions for personal, living and family expenditures to offset the wages reported on the federal income tax return. Taxpayer A claims that compensation received for personal services is not subject to federal income tax.

Arguments that wages are not subject to federal income tax take many forms including, but not limited to, the following:

1. A tax on wages is a direct tax subject to the provision in Article I, Section 2, Clause 3 of the Constitution that requires that direct taxes be apportioned among the states by population.
2. Money received in exchange for personal labor constitutes an equal, nontaxable exchange of property.

3. Taxable income from wages or other compensation for personal services can only be determined after deduction of the cost of providing the labor.

LAW AND ANALYSIS

1. Article 1, Section 2, Clause 3 of the United States Constitution states that “direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers” This statement has been used to support the argument that there is a constitutional impediment to the imposition of a direct tax on an individual’s wages. The Sixteenth Amendment to the Constitution, ratified in 1913, provides that “[t]he 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.” The Sixteenth Amendment has been reviewed by the Supreme Court and upheld. Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916). Thus, the imposition of income tax on wages, without apportionment among the states, is authorized. See, e.g., Funk v. Commissioner, 687 F.2d 264 (8th Cir. 1982); Abrams v. Commissioner, 82 T.C. 403 (1984).

Section 61(a) of the Internal Revenue Code defines gross income as income from whatever source derived, including (but not limited to) “compensation for services, including fees, commissions, fringe benefits, and similar items.” I.R.C. § 61(a)(1). Courts consistently have upheld the determination that wages fall within section 61(a)(1)’s definition of compensation and, accordingly, constitute taxable income. See,

e.g., Ledford v. United States, 297 F.3d 1378 (Fed. Cir. 2002); United States v. Connor, 898 F.2d 942 (3d Cir. 1990); Casper v. Commissioner, 805 F.2d 902 (10th Cir. 1986); Connor v. Commissioner, 770 F.2d 17 (2d Cir. 1985); Lovell v. United States, 755 F.2d 517 (7th Cir. 1984); Perkins v. Commissioner, 746 F.2d 1187 (6th Cir. 1984); Funk v. Commissioner, 687 F.2d 264 (8th Cir. 1982); Lonsdale v. Commissioner, 661 F.2d 71 (5th Cir. 1981); Rowlee v. Commissioner, 80 T.C. 1111 (1983).

In United States v. Connor, 898 F.2d. at 943, the Third Circuit noted that “[e]very court which has ever considered the issue has unequivocally rejected the argument that wages are not income.” All income received by a taxpayer is income under section 61 unless it is specifically exempted or excluded. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-30 (1955) (“Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to the intention of Congress to tax all gains except those specifically exempted.”).

2. Some taxpayers claim that the payment of wages or other compensation in exchange for personal labor is a nontaxable exchange of property. These taxpayers sometimes rely on sections 83 or 1001 of the Internal Revenue Code to support this argument. Section 83 provides for the determination of the amount to be included in gross income and the timing of the inclusion when property is transferred to an employee or independent contractor in connection with the performance of services. Section 1001 provides for the determination of the amount and timing of the recognition of gain or loss from the sale or other disposition of property.

Courts have universally rejected the argument that labor is property that can be exchanged for wages or other compensation in a nontaxable transaction. See Casper v. Commissioner, 805 F.2d at 905; Funk v. Commissioner, 687 F.2d at 265. Courts recognize a distinction between selling labor and selling or exchanging property. See Reading v. Commissioner, 70 T.C. 730, 733-34 (1978), aff'd, 614 F.2d 159 (8th Cir. 1980). Further, the courts have concluded that a taxpayer has no tax basis in one's labor and, therefore, the full amount of the wages or other compensation received represents gain which may be taxed as income. See, e.g., Casper, 805 F.2d at 905; Abrams, 82 T.C. at 407; Reading, 70 T.C. at 733-34.

3. A related argument is that income from the sale of labor cannot be determined until the taxpayer's investment in that labor has been recovered. This argument has been repeatedly rejected. See Rowlee, 80 T.C. at 1120; Reading, 70 T.C. at 733-34. In Reading, the Tax Court examined the contention that gain must be realized for there to be income, analyzing the distinction recognized under federal tax law between producing a physical product and providing services. The court flatly rejected the idea that living expenses constitute the cost of "goods" sold for providing labor or services. Reading, 70 T.C. at 733-34. Thus, the court concluded that the gain from the sale of labor is the entire amount received and upheld the disallowance of deductions for personal living expenses.

Courts have uniformly rejected arguments that wages and other compensation for personal services are not taxable income. Accordingly, raising these arguments justifies the imposition of sanctions. See Ledford v. United States, 297 F.3d at 1381-82

(Fed. Cir. 2002); Casper v. Commissioner, 805 F.2d at 906; Connor v. Commissioner, 770 F.2d at 20.

HOLDING

1. Wages fall within the definition of income set forth in section 61(a)(1) of the Internal Revenue Code. Taxpayer A's wages and other compensation for services are income subject to federal income tax and must be reported on Taxpayer A's federal income tax return.
2. The payment of wages and other compensation for personal services is not an equal exchange of property. The full amount of wages received by Taxpayer A is subject to federal income tax and must be reported on Taxpayer A's federal income tax return.
3. Wages and other compensation received by Taxpayer A in exchange for personal services are subject to federal income tax without reduction of Taxpayer A's personal living expenses.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who improperly attempt to avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay tax based on arguments that wages and other compensation for personal services are exempt from federal income tax face substantial civil and criminal penalties. Potentially applicable civil

penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of tax the taxpayer should have paid; (3) the section 6702(a) penalty of \$5,000 for a “frivolous tax return”; (4) the section 6702(b) penalty of \$5,000 for submitting a “specified frivolous submission”; (5) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; (6) the section 6673 penalty of up to \$25,000 if the taxpayer makes frivolous arguments in the United States Tax Court; and (7) the section 6682 penalty of \$500 for providing false information with respect to withholding.

Taxpayers relying on these frivolous positions also may face criminal prosecution under: (1) section 7201 for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years; (2) section 7203 for willful failure to file a return, the penalty for which is a significant fine and imprisonment for up to one year; (3) section 7206 for making false statements on a return, statement, or other document, the penalty for which is a significant fine and imprisonment for up to 3 years; or (4) other provisions of federal law.

Persons, including return preparers, who promote these frivolous positions and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a \$250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who

knew or should have known that the taxpayer's position was frivolous (or \$1,000 for each return or claim for refund if the return preparer's actions were willful, intentional or reckless); (2) a penalty under section 6700 for promoting abusive tax shelters; (3) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (4) criminal prosecution under section 7206, for which the penalty is a significant fine and imprisonment for up to 3 years, for assisting or advising about the preparation of a false return, statement or other document under the internal revenue laws.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622-7950 (not a toll-free call).

