

NOTICE 2006-31 , I.R.B. 2006-15, MARCH 16, 2006.

[Code Secs. 32, 44, 280A, 3401, 6011, 6065, 6111, 6651, 6662, 6663, 6673, 6701, 6702, 7203, 7206, 7408 and 7804]

Avoidance of tax: Tax shelters: Penalties, civil: Penalties, criminal: Failure to file return: Failure to pay tax: Filing false return: Frivolous return: Negligence: Fraud penalties: Injunction: Tax protestors: Sixteenth Amendment challenge to tax: Thirteenth Amendment: Slavery reparations: Social Security taxes: Verification of returns: Jurat: Sham trusts. — The IRS has listed some of the most common frivolous arguments used by abusive tax-avoidance schemes. While it is not intended to be a definitive listing of all frivolous positions, it does describe 26 such arguments. The IRS also points out that civil and criminal penalties may apply to individuals who make frivolous arguments. Persons who promote frivolous positions and those who assist taxpayers in claiming tax benefits based on such positions may also face penalties. Notice 2005-30, I.R.B. 2005-14, 827, is modified and superseded. Back references: ¶2900.112, ¶2900.56, ¶2900.897, ¶3100.10, ¶4082.35, ¶4401.25, ¶14,854.84, ¶33,506.021, ¶33,533.046, ¶33,533.25, ¶35,141.78, ¶35,141.80, ¶36,686.021, ¶36,686.16, ¶39,475.255, ¶39,652.72, ¶39,658.71, ¶39,790.77, ¶40,035.10, ¶40,043.52, ¶41,318.41, ¶41,333.10 and ¶43,266.3025.

SECTION 1. INTRODUCTION.

As April 15 approaches, the Internal Revenue Service reminds taxpayers to steer clear of abusive tax-avoidance schemes that purportedly allow them to reduce or eliminate taxes based on false or frivolous arguments. If an idea to save on taxes seems too good to be true, it probably is.

Many abusive tax-avoidance schemes are based on frivolous arguments that the Service and the courts have repeatedly rejected. These schemes are often sold by promoters for a substantial fee, and may be sold over the Internet, through advertisements in newspapers and magazines and at conferences and seminars.

Section 2 of this Notice sets out some of the most common frivolous arguments used by these abusive tax-avoidance schemes. 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 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 or criminal penalties should apply.

Section 3 of this Notice identifies potential civil and criminal penalties for participation in, or promotion of, abusive tax-avoidance schemes. Taxpayers who engage in abusive tax-avoidance schemes will be liable for unpaid taxes and interest. In addition, the Service will impose civil and criminal penalties against taxpayers where appropriate. The Service also will impose appropriate penalties and consider taking other appropriate action against persons who promote abusive tax-avoidance schemes and who prepare frivolous returns based on those schemes.

SECTION 2. COMMON FRIVOLOUS ARGUMENTS.

This section of this Notice sets out some of the most common frivolous arguments used by taxpayers to avoid or evade tax. This Notice is not intended to be a description of all frivolous arguments used to avoid or evade tax. Accordingly, the fact that an abusive tax-avoidance scheme is not described in this Notice does not mean that it is not false and frivolous.

- ◆ “The only persons subject to federal income and employment taxation are federal employees and persons residing in Washington, D.C., or federal territories.” Promoters of this scheme incorrectly advise taxpayers who receive wages with respect to employment to file a Form 4852 (Substitute for Form W-2) with the Service and, based on the above theory, include a zero on the line for the amount of wages received. The Internal Revenue Code, however, imposes a federal income tax upon all United States residents and citizens, not just federal employees and those that reside in Washington, D.C., federal territories, and federal enclaves. The Internal Revenue Code also imposes employment tax on all wages paid for employment.
- ◆ “A taxpayer can avoid tax by filing a return that reports zero income and zero tax liability.” All taxpayers who meet minimum income thresholds must file returns and pay any tax owed on their taxable income. No law, including the Internal Revenue Code, permits a taxpayer who has received wages or other taxable income to file a return reporting zero income and zero tax liability. If a taxpayer has received income subject to federal tax, a return showing only zeroes for income and tax liability is not a valid return. Further, inclusion of the phrase “nunc pro tunc” or other legal jargon on an income tax return does not serve to validate an otherwise improper return.
- ◆ “A taxpayer can avoid income tax by referring to a separate ‘straw man’ entity created by the use of the taxpayer’s name in all capital letters, or other variations of a taxpayer’s name, in government documents.” No authority supports the claim that individuals may avoid their federal income tax obligations based on “straw man” arguments. The use of all uppercase letters, italics, abbreviations or other formats of an individual’s name in government documents has no significance whatsoever.
- ◆ “Wages are not taxable income, pursuant to section 1001, because taxpayers have basis in their labor equal to the fair market value of the wages they receive; thus, there

is no gain to be taxed." With few exceptions, compensation received, no matter what the form of payment, must be included in gross income under section 61. This includes salary or wages paid in cash, as well as the value of property and other economic benefits received as remuneration for services performed or to be performed in the future. Section 1001 governs gain or loss on the disposition of property, and does not apply to compensation for services.

- ◆ "The 16th Amendment is invalid because it contradicts the original Constitution, was not properly ratified, and lacks an enabling clause." The Sixteenth Amendment to the U.S. Constitution, which authorizes the income tax, was properly ratified by the states and is valid. Further, the argument that the Sixteenth Amendment is invalid due to the lack of an enabling clause is without merit because Congress has the power to lay and collect taxes pursuant to Article 1, Section 8, Clause 18 of the Constitution.
- ◆ "A taxpayer can make a 'claim of right' to exclude the cost of his labor from income." There is no "claim of right" doctrine under any federal law, including the Internal Revenue Code, that permits a taxpayer to deduct or exclude from gross income the value of his labor.
- ◆ "Only income from a foreign source is taxable under section 861." Sections 861 through 865 do not exclude income derived in the U.S. from taxable income. In particular, nothing in these sections or the Treasury regulations under these sections provides that only income earned from certain foreign sources is subject to U.S. income tax.
- ◆ "I am not a 'citizen' or a 'person' within the meaning of the Internal Revenue Code." A citizen of any one of the 50 States (e.g., New York, California) of the United States or of the District of Columbia, including those living abroad, is also a citizen of the United States and is subject to federal tax. The Internal Revenue Code defines a taxpayer as any person subject to any internal revenue tax and further defines a person as an individual, trust, estate, partnership, association, company or corporation.
- ◆ "Residents of states, such as New York or California, are residents of a foreign country and therefore not subject to U.S. income tax." Under its specific conditions and limitations, section 911 permits a taxpayer to elect to exclude income from U.S. taxable income only when the taxpayer earns income abroad and resides outside the geographic boundaries of the United States. For purposes of section 911, each of the 50 states, the District of Columbia, and commonwealths and territories of the United States (e.g., Johnston Atoll), are not foreign countries.
- ◆ "A taxpayer can escape income tax by putting assets in an offshore bank account." A citizen or resident of the United States cannot use an offshore financial arrangement (such as a foreign bank or brokerage account, or a credit card issued by a foreign bank) to avoid his federal tax obligations. Taxpayers are required to disclose foreign financial accounts to the Treasury Department and to report the income earned thereon.

- ◆ “A taxpayer can eliminate tax by establishing a ‘corporation sole.’” A taxpayer cannot avoid income tax by establishing a “corporation sole.” A corporation sole may be used only by a legitimate religious leader for specific, limited purposes relating to the religious leader’s office.
- ◆ “A taxpayer can place all of his assets in a trust to escape income tax while still retaining control over those assets.” A taxpayer who places assets in a trust but retains certain powers over or interests in the assets, including the power to control the beneficial enjoyment of the assets, is treated as the owner of the assets for federal tax purposes and is subject to tax on the income from those assets.
- ◆ “A taxpayer can eliminate tax by attributing his income to a trust and filing a Form 1041, U.S. Income Tax Return for Estates and Trusts, instead of a Form 1040, U.S. Individual Income Tax Return.” A taxpayer must report income earned as an individual on a Form 1040 and may not attribute the income to a trust created solely for the purpose of tax-avoidance, or claim deductions related to any expenses purportedly incurred by such a trust.
- ◆ “A taxpayer can deduct amounts paid to maintain his household and for other personal expenses by establishing a home business.” Business expenses, including expenses related to a home-based business, are not deductible unless the expenses relate to a legitimate profit-seeking trade or business. Promoters of home-based business schemes improperly encourage taxpayers to claim household expenses as business expense deductions when the purported home-based business is not a legitimate trade or business.
- ◆ “Nothing in the Internal Revenue Code imposes a requirement to file a return.” Section 6011 expressly authorizes the Service to require, by Treasury regulation, the filing of tax returns. Section 6012 identifies persons who are required to file income tax returns. The Treasury Department has issued regulations requiring taxpayers who meet minimum income thresholds to file income tax returns. Taxpayers also are required to pay any tax owed. Moreover, no provision of the Paperwork Reduction Act serves to exempt taxpayers from the requirement that they file returns.
- ◆ “Filing a tax return is ‘voluntary.’” Some people mistake the word “voluntary” for “optional” - but filing a tax return is not optional for those who meet the law’s minimum gross income requirements. The word “voluntary,” as used in IRS publications, court decisions and elsewhere, refers to the fact that the U.S. tax system is a voluntary compliance system. This means only that taxpayers themselves determine the correct amount of tax pursuant to law and complete the appropriate returns, rather than have the government do this for them as is done in some other countries. This system of self-reporting does not make the filing of tax returns or the payment of tax optional. For those who do not comply with this system and fail to self-report their tax liability, the tax law authorizes various enforced compliance measures.
- ◆ “Because taxes are voluntary, as an employer, I don’t have to withhold income or

employment taxes for my employees." Every taxpayer is responsible for completing and filing required returns and paying the correct amount of tax. An employer is required by law to withhold income and employment taxes from wages paid to employees. Employers also must deposit the amounts withheld with the Service.

- ◆ "A taxpayer can refuse to pay taxes if the taxpayer disagrees with the government's use of the taxes it collects." No law, including the Internal Revenue Code, permits a taxpayer to avoid or evade tax obligations on the grounds that the taxpayer does not agree with the government's use of the taxes collected.
- ◆ "A taxpayer can escape income taxes or the tax system by submitting a set of documents in lieu of a tax return." Taxpayers must file income tax returns using the forms prescribed by the Service. No law, including the Internal Revenue Code, permits taxpayers to submit a document or series of documents to remove themselves from the income tax system.
- ◆ "A taxpayer can avoid tax by filing a return with an attachment that disclaims tax liability." A return with an attached disclaimer of tax liability is not a valid tax return under the law and does not exempt the taxpayer from tax.
- ◆ "A taxpayer can avoid tax by filing a return with an altered penalties of perjury statement." Alterations to the form of an income tax return or to the penalties of perjury statement on the return do not permit a taxpayer to avoid tax. Such alterations may invalidate a return and subject the taxpayer to penalties for failure to file a return.
- ◆ "Certain taxpayers can claim a 'reparations tax credit' to right wrongs done in the past." No law, including the Internal Revenue Code, permits a "reparations tax credit."
- ◆ "Native American taxpayers can avoid their federal income tax liability by claiming tax exempt status based on an unspecified 'Native American Treaty.'" Native Americans are subject to the same income tax laws as other U.S. citizens unless there is an exemption explicitly created by treaty or statute. Although there are numerous valid treaties between various Native American tribes and the U.S. government, any tax exemption under these treaties applies only to the specific tribe. There is no general "Native American Treaty" applicable to all Native Americans.
- ◆ "By purchasing equipment and services for an inflated price, a taxpayer can use the Disabled Access Credit to reduce tax or generate a refund." The section 44 Disabled Access Credit is only applicable to purchases or modifications of equipment and services that are necessary for a small business to comply with the access requirements of the Americans with Disabilities Act. Promoters of this scheme improperly promise eligibility for the credit when they sell equipment or services with questionable ties to the requirements of the Americans with Disabilities Act at inflated prices, often to persons who do not operate legitimate businesses, while not requiring the participating taxpayer to pay the entire price stated in the contract.

- ◆ “Under section 3121 taxpayers can deduct the amount of Social Security taxes paid or get a refund of those taxes.” The Internal Revenue Code imposes Social Security tax on wages as defined in section 3121. Aside from the narrow exception for a religious exemption under section 3127, a taxpayer may not exclude wages from Social Security taxation on the basis that the taxpayer is waiving the right to receive Social Security benefits. The Code does not authorize a deduction for, or refund of, Social Security taxes paid.
- ◆ “A taxpayer can sell or purchase the right to claim a child as a qualifying child for purposes of the EIC.” A taxpayer may not purchase or sell the right to claim a child as a qualifying child for purposes of the earned income credit (EIC). In order to be claimed as a qualifying child for purposes of the EIC, the child must meet specific relationship, residency and age requirements.

The Service and the courts have repeatedly rejected these arguments and variations on them, and have rejected numerous other tax-avoidance schemes and frivolous arguments used by taxpayers to avoid or evade taxes.

SECTION 3. CIVIL AND CRIMINAL PENALTIES.

Civil and criminal penalties may apply to taxpayers who make frivolous arguments. Potentially applicable civil penalties include: (1) 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; (2) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of taxes the taxpayer should have paid; (3) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (4) a \$500 penalty under section 6702 for filing a frivolous income tax return; and (5) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers who take 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 fine of up to \$25,000 and imprisonment for up to one year; and (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.

Persons, including return preparers, who promote frivolous positions and those who assist taxpayers in claiming tax benefits based on frivolous positions may face penalties and 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.

SECTION 4. EFFECT ON OTHER DOCUMENTS.

Notice 2005-30 is modified and superseded.

SECTION 5. ADDITIONAL INFORMATION.

Other information about frivolous tax positions is available on the Service website at www.irs.gov.

This notice was authored by the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact that office at (202) 622-7800 (not a toll-free call).