TAX DEPOSITION QUESTIONS: 2. RIGHT TO LABOR

2. RIGHT TO LABOR

Introduction

Labor is property. It is the most valuable property protected by law because through it all other rights manifest in the People are realized and enjoyed.

Additionally, a mandatory income tax on labor is indistinguishable from a "slave tax". This is in direct violation of the Constitution's 13th Amendment prohibiting peonage and involuntary servitude.

Findings and Conclusions

With the assistance of the following series of questions, we intend to prove that the income tax is a slave tax prohibited by the Thirteenth Amendment to the U.S. Constitution. We will also show that:

- **Labor is property. It is the most valuable property to protect because through it all other rights manifest in the People are realized and enjoyed.**
- **Under the government's own accounting rules in the tax code as well as court decisions, the sale or conversion of one's personal labor into wages or salaries as property does not result in any taxable income or a taxable event.**
- **There is no legal basis for mandatory payment of employment taxes on wages or salaries.**
- **Income has been defined by the Supreme Court as being a federal corporate tax on profit, and applies to federal corporations and the officers of those corporation, but not individuals.**
- **For individuals, income taxes can only be legal if they are voluntary and not compelled, which is to say that they are not taxes, but donations.**
- **A mandatory/compelled income tax on labor in all respects, functions as a "slave tax". This is in direct violation the Constitution's 13th Amendment prohibiting peonage and involuntary servitude.**

Bottom Line: The wages and salaries of ordinary Americans cannot be taxed.

Section Summary

Witnesses:

- Larry Becraft (Constitution Attorney)
- Sherry Peel Jackson (Ex. IRS Examiner, CPA, Certified Fraud Examiner)

Transcript

Acrobat version of this section including questions and evidence (large: 8.89 Mbytes)

Further Study On Our Website:

- Is the Income Tax a Form of Slavery?
- How the Government Defrauds You Out of Legitimate Deductions for the Market Value of Your Labor, Form

#05.026 (OFFSITE LINK) -SEDM
- Social Security: Idolatry and Slavery
- Great IRS Hoax book:
    - Section 2.8.5: Federal Reserve
    - Section 2.8.6: Debt
    - Section 3.10.9: Thirteenth Amendment: Abolition of Slavery
    - Section 5.4.1: Direct Income Taxes are Slavery
    - Section 5.6.6: The Definition of "income" for the purpose of Income Taxes
- Sovereignty Forms and Instructions Manual book:
    - Section 2.4.1: How Does the Government Apply Duress and What is the Remedy For It?
- Socialism v. Capitalism: Which is the Moral System?

2.1. Admit that it was the intent of Congress to require "individuals" to make income tax returns based upon receipt of more than a threshold amount of gross income even if the individual ends up not "liable for" a tax on that gross income. (WTP #122)

2.2. Admit that the "gross income" mentioned in Section 6012 of the Internal Revenue Code is the "gross income" as set forth at Section 61(a) of the Internal Revenue Code. (WTP #123)

- Click here for 26 U.S.C. §61 (WTP Exhibit 063)
- Click here for 26 U.S.C. §6012 (WTP Exhibit 020)

2.3. Admit that Section 61(a) of the Internal Revenue Code defines "gross income" as "all income" from whatever source derived, but does not define "income." (WTP #063)

- Click here for 26 U.S.C. §61

2.4. Admit that in Eisner v. Macomber, 252 U.S. 189, 206 (1920), the United States Supreme Court held that Congress cannot by any definition it may adopt conclude what "income" is, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised. (WTP #125)

- Click here for Eisner v. Macomber, 252 U.S. 189, 206(192)

2.5. Admit that the definition of "income" as it appears in Section 61(a) is based upon the 16th Amendment and that the word is used in its constitutional sense. (WTP #126)

- Click here for 26 U.S.C. §61
- Click here for Sixteenth Amendment

2.6. Admit that the United States Supreme Court has defined the term "income" for purposes of all income tax legislation as: (WTP #127)

"The gain derived from capital, from labor or from both combined, provided it include profit gained

through a sale or conversion of capital assets."

- Click here for Stratton's Independence v. Howbert, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913) (WTP Exhibit 065)
- Click here for Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185, 38 S.Ct. 467 (1918) (WTP Exhibit 066)
- Click here for So. Pacific v. Lowe, 247 U.S. 330 (1918) (WTP Exhibit 067)
- Click here for Eisner v. Macomber, 252 U.S. 189 (1920) (WTP Exhibit 054)
- Click here for Merchant's Loan v. Smietanka, 255 U.S. 509 (1921) (WTP Exhibit 068)

2.7. Admit that the United States Supreme Court defined "income" to mean the following: (WTP #127a)

*"...Whatever difficulty there may be about a **precise scientific definition of 'income**,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; **conveying rather the idea of gain or increase arising from corporate activities**."*
***Doyle v. Mitchell Brothers Co.**, 247 U.S. 179, 185, 38 S.Ct. 467 (1918) [emphasis added]*

- Click here for Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185, 38 S.Ct. 467 (1918) (WTP Exhibit 066)

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*"This court had decided in the Pollock Case that the income tax law of 1894 amounted in effect to a direct tax upon property, and was invalid because not apportioned according to populations, as prescribed by the Constitution. The act of 1909 avoided this difficulty by imposing not an income tax, but an **excise tax upon the conduct of business in a corporate capacity**, measuring, however, the amount of tax by the income of the corporation...**Flint v. Stone Tracy Co**., 220 U.S. 107, 55 L.Ed. 389, 31 Sup.Ct.Rep. 342, Ann. Cas."*
***[Stratton's Independence v. Howbert**, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913)]*

- Click here for Stratton's Independence v. Howbert, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913) (WTP Exhibit 065)

2.8. Admit that the term "corporation" as used above infers a *federally chartered* and not a state chartered corporation. (WTP #127b)

2.9. Admit that the United States Government is defined as a federal corporation: (WTP #127c)

United States Code
TITLE 28 - JUDICIARY AND JUDICIAL PROCEDURE
PART VI - PARTICULAR PROCEEDINGS
CHAPTER 176 - FEDERAL DEBT COLLECTION PROCEDURE
SUBCHAPTER A - DEFINITIONS AND GENERAL PROVISIONS
Sec. 3002. Definitions
*(15) **"United States" means** -*
*(A) **a Federal corporation**;*
(B) an agency, department, commission, board, or other entity of the United States; or
(C) an instrumentality of the United States.

- Click here for 28 U.S.C. §3002 (WTP Exhibit 068a)

2.10. Admit that "individuals" as defined in Subtitle A of the Internal Revenue Code and in 26 CFR §1.1441-1(c)(3) are not federal corporations, and therefore cannot have "profit" or "gain" as constitutionally defined above. (WTP #127d)

- Click here for 26 CFR. §1.1441-1(c)(3) (WTP Exhibit 017b)

2.11. Admit that in the absence of gain, there is no "income." (WTP #128)

- Click here for Stratton's Independence v. Howbert, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913) (WTP Exhibit 065)
- Click here for Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185, 38 S.Ct. 467 (1918) (WTP Exhibit 066)
- Click here for So. Pacific v. Lowe, 247 U.S. 330 (1918) (WTP Exhibit 067)
- Click here for Eisner v. Macomber, 252 U.S. 189 (1920) (WTP Exhibit 054)
- Click here for Merchant's Loan v. Smietanka, 255 U.S. 509 (1921) (WTP Exhibit 068)

2.12. Admit that there is a difference between gross receipts and gross income. (WTP #129)

2.13. Admit that the United States Supreme Court recognizes that one's labor constitutes property. (WTP #130)

2.14. Admit that the United States Supreme Court stated in Butchers' Union Co. v. Crescent City Co., 111 U.S. 746, 757 (concurring opinion of Justice Fields) (1883), that: (WTP #131)

> *"It has been well said that, "The property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable."*

- Click here Butcher's Union Co. v. Crescent City Co., 111 U.S. 746, 757 (WTP Exhibit 070)

2.15. Admit that the United States Supreme Court recognizes that contracts of employment constitute property. (WTP #132)

- Click here for Stratton's Independence v. Howbert, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913) (WTP Exhibit 065)
- Click here for Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185, 38 S.Ct. 467 (1918) (WTP Exhibit 066)
- Click here for So. Pacific v. Lowe, 247 U.S. 330 (1918) (WTP Exhibit 067)
- Click here for Eisner v. Macomber, 252 U.S. 189 (1920) (WTP Exhibit 054)
- Click here for Merchant's Loan v. Smietanka, 255 U.S. 509 (1921) (WTP Exhibit 068)
- Click here Butcher's Union Co. v. Crescent City Co., 111 U.S. 746, 757 (WTP Exhibit 070)

2.16. Admit that the United States Supreme Court stated in Coppage v. Kansas, 236 U.S. 1, 14 (1914) that: (WTP #133)

> *"The principle is fundamental and vital. Included in the right of personal liberty and the right of private property-partaking of the nature of each-is the right to make contracts for the acquisition of property. Chief among such contracts is that of personal employment, by which labor and other services are exchanged for money or other forms of property."*

- Click here Coppage v. Kansas, 236 U.S. 1, 14 (1914) (WTP Exhibit 071)

2.17. Admit that the United States Supreme Court recognizes that a contract for labor is a contract for the sale of property. (WTP #134)

- Click here for Stratton's Independence v. Howbert, 231 U.S. 399, 414, 58 L.Ed. 285, 34 Sup.Ct. 136 (1913) (WTP Exhibit 065)
- Click here for Doyle v. Mitchell Brothers Co., 247 U.S. 179, 185, 38 S.Ct. 467 (1918) (WTP Exhibit 066)
- Click here for So. Pacific v. Lowe, 247 U.S. 330 (1918) (WTP Exhibit 067)
- Click here for Eisner v. Macomber, 252 U.S. 189 (1920) (WTP Exhibit 054)
- Click here for Merchant's Loan v. Smietanka, 255 U.S. 509 (1921) (WTP Exhibit 068)
- Click here Butcher's Union Co. v. Crescent City Co., 111 U.S. 746, 757 (WTP Exhibit 070)

2.18. Admit that the United States Supreme Court has stated in Adair v. United States, 208 U.S. 161, 172 (1908) that: (WTP #135)

> *"In our opinion that section, in the particular mentioned, is an invasion of the personal liberty, as well as of the right of property, guaranteed by that Amendment (5th Amendment). Such liberty and right embraces the right to make contracts for the purchase of the labor of others and equally the right to make contracts for the sale of one's own labor."*

- Click here Adair v. United States, 208 U.S. 161, 172 (1980) (WTP Exhibit 072)

2.19. Admit that Congress recognizes at Section 64 of the Internal Revenue Code that "ordinary income" is a gain from the sale or exchange of property. (WTP #136)

- Click here for 26 U.S.C. §64 (WTP Exhibit 073)

2.20. Admit that Internal Revenue Code Sections 1001, 1011 and 1012 provide the method Congress has set forth for determining the gain derived from the sale of property. (WTP #137)

- Click here for 26 U.S.C. §1001 (WTP Exhibit 074)
- Click here for 26 U.S.C. §1011 (WTP Exhibit 075)
- Click here for 26 U.S.C. §1012 (WTP Exhibit 076)

2.21. Admit that Section 1001(a) states that: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . ." (WTP #138)

- Click here for 26 U.S.C. §1001 (WTP Exhibit 074)

2.22. Admit that Section 1001(b) states that: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." (WTP #139)

- Click here for 26 U.S.C. §1001 (WTP Exhibit 074)

2.23. Admit that Section 1011 states that: "The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012...), adjusted as provided in section 1016." (WTP #140)

- Click here for 26 U.S.C. §1011 (WTP Exhibit 075)

2.24. Admit that Section 1012 states that: "The basis of property shall be the cost of such property . . . ." (WTP #141)

- Click here for 26 U.S.C. §1012 (WTP Exhibit 076)

2.25. Admit that the cost of property purchased under contract is its fair market value as evidenced by the contract itself, provided neither the buyer nor sell were acting under compulsion in entering into the contract, and both were fully aware of all the facts regarding the contract. (WTP #142)

- Click here to see Terrance Development Co. v. C.I.R., 345 F.2d 933 (1965) (WTP Exhibit 077)
- Click here to see Bankers Trust Co. v. U.S., 518 F.2d 1210 (1975) (WTP Exhibit 078)
- Click here to see Bar L. Ranch. Inc. v. Phinney, 426 F.2d 995 (1970) (WTP Exhibit 079)
- Click here to see Jack Daniel Distillery v. U.S., 379 F.2d 569 (1967) (WTP Exhibit 080)
- Click here to see In re Williams' Estate, 256 F.2d 217 (1958) (WTP Exhibit 081)

2.26. Admit that in the case of the sale of labor, none of the provisions of Section 1016 of the Internal Revenue Code are applicable. (WTP #143)

- Click here for 26 U.S.C. §1016 (WTP Exhibit 082)

2.27. Admit that when an employer pays the employee the amount agreed upon by their contract, there is no excess amount realized over the adjusted basis, and thus no gain under Section 1001 of the Internal Revenue Code. (WTP #144)

- Click here for 26 U.S.C. §1001 (WTP Exhibit 074)

2.28. Admit that if one has no gain, one would have no income in a constitutional sense. (See 26 U.S.C. §1001) (WTP #145)

- Click here for 26 U.S.C. §1001 (WTP Exhibit 074)

2.29. Admit that if one has no income, one would have no "gross income." [Common knowledge] (WTP #146)

2.30. Admit that in the absence of "gross income," one would not be required to make a return under Section 6012 of the Internal Revenue Code. (See 26 U.S.C. § 6012.) (WTP #147)

- Click here for 26 U.S.C. §6012 (WTP Exhibit 020)

2.31. Admit that Section 6017 of the Internal Revenue Code requires individuals, other than nonresident alien individuals, to make a return if they have net earnings from self-employment of $400 or more. (WTP #148)

- Click here for 26 U.S.C. §6017 (WTP Exhibit 084)

2.32. Admit that the term "net earnings from self-employment" is defined at Section 1402(a) of the Internal Revenue Code as follows: (WTP #149)

> *"The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or business carried on by such individual . . . ."*

- Click here for 26 U.S.C. §1402 (WTP Exhibit 085)

2.33. Admit that in the absence of "gross income," one would not have more than $400 of "net earnings from self-employment." (WTP #150)

- Click here for 26 U.S.C. §1402 (WTP Exhibit 085)

2.34. Admit that the "taxable income" upon which the income tax is imposed in Section 1 of the Internal Revenue Code is defined at Section 63 of the Internal Revenue Code. (WTP #151)

- Click here for 26 U.S.C. §1 (WTP Exhibit 002)
- Click here for 26 U.S.C. §63 (WTP Exhibit 086)

2.35. Admit that the term "taxable income" is defined differently for those who itemize deductions and those who don't itemize deductions. (See questions 2.36 and 2.37 below) (WTP #152)

2.36. Admit that for those who do itemize deductions, the term "taxable income" means "gross income" minus the deductions allowed by Chapter 1 of the Internal Revenue Code, other than the standard deduction. (WTP #153)

- Click here for evidence (WTP Exhibit 088)

2.37. Admit that for those who do not itemize deductions, the term "taxable income" means "adjusted gross income" minus the standard deduction and the deduction or personal exemptions provided in section 151 of the Internal Revenue Code. (WTP #154)

- Click here for evidence (WTP Exhibit 088)
- Click here for 26 U.S.C. §151 (WTP Exhibit 089)

2.38. Admit that for individuals, the term "adjusted gross income" means gross income minus certain deductions. (WTP #155)

- Click here for 26 U.S.C. §62 (WTP Exhibit 162)

2.39. Admit that in the absence of "gross income" an individual would have no "adjusted gross income" and no "taxable income." (WTP #156)

- Click here for 26 U.S.C. §3101 (WTP Exhibit 92)

2.40. Admit that in the absence of taxable income, no tax is imposed under Section 1 of the Internal Revenue Code. (WTP #157)

- Click here for 26 U.S.C. §1 (WTP Exhibit 002)

2.41. Admit that employment taxes are contained in Subtitle C of the Internal Revenue Code. (WTP #158)

- Click here for Title 26, United States Code, index (WTP Exhibit 001)

2.42. Admit that the taxes imposed in Subtitle C of the Internal Revenue Code are different than the taxes imposed in Subtitle A of the Internal Revenue Code. (WTP #159)

- Click here for Title 26, United States Code, index (WTP Exhibit 001)

2.43. Admit that The Federal Insurance Contributions Act (FICA) tax contained in Subtitle C at Section 3101 of the Internal Revenue Code is imposed on the individual's "income." (WTP #160)

- Click here for 26 U.S.C. §3101 (WTP Exhibit 092)

2.44. Admit that the rate of the tax set out at Section 3101 of the Internal Revenue Code is a percentage of the individual's wages. (WTP #161)

- Click here for 26 U.S.C. §3101 (WTP Exhibit 092)

2.45. Admit that the term "income" as used at Section 3101 of the Internal Revenue Code is the same income as used in Subtitle A of the Internal Revenue Code. (See 26 U.S.C. 3101; Title 26, United States Code Index) (WTP #162)

- Click here for 26 U.S.C. §3101 (WTP Exhibit 092)
- Click here for Title 26, United States Code, index (WTP Exhibit 001)

2.46. Admit that if one has no income, one is not subject to the tax imposed at Section 3101 of the Internal Revenue Code. (WTP #163)

- Click here for 26 U.S.C. §3101 (WTP Exhibit 093)

2.47. Admit that The Federal Insurance Contributions Act (FICA) tax on employers contained in Subtitle C at Section 3111 of the Internal Revenue Code is an excise tax on employers with respect to their having employees. (WTP #164)

- Click here for 26 U.S.C. §3111 (WTP Exhibit 094)

2.48. Admit that at Section 3402 of the Internal Revenue Code, employers are directed to withhold from wages paid to employees, a tax determined in accordance with tables prescribed by the Secretary of the Treasury. (WTP #165)

- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)

2.49. Further admit that Congress does not identify the Section 3402 "tax determined" as either a direct tax, an indirect tax, and/or an "income" tax. (WTP #166)

- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)

2.50. Admit that Congress made the employer liable for the Section 3402 tax at Section 3403 of the Internal Revenue Code. (WTP #167)

- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)
- Click here for 26 U.S.C. §3403 (WTP Exhibit 096)

2.51. Admit that at Section 3501 of the Internal Revenue Code, Congress directed the Secretary of the Treasury to collect the taxes imposed in Subtitle C and pay them into the Treasury of the United States as internal revenue collections. (WTP #168)

- Click here for 26 U.S.C. §3501 (WTP Exhibit 097)

2.52. Admit that Congress has not anywhere imposed the tax described at Section 3402 of the Internal Revenue Code. (WTP #169)

- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)
- See Title 26, United States Code, in its entirety

2.53. Admit that at Section 31 of the Internal Revenue Code, the amount of the Section 3402 tax on wages is allowed as a credit against the income tax imposed in Subtitle A. (WTP #170)

- Click here for 26 U.S.C. §1 (WTP Exhibit 001)
- Click here for 26 U.S.C. §31 (WTP Exhibit 098)
- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)

2.54. Admit that if one does not have any tax imposed at Subtitle A for any reason whatsoever, the law enacted by Congress at Section 3402(n) of the Internal Revenue Code constitutes an exemption of the tax described at Section 3402 (a) of the Internal Revenue Code. (WTP #171)

- Click here for 26 U.S.C. §3402 (WTP Exhibit 095)

2.55. Admit that a typical American family works until noon of every working day just to pay its alleged tax obligations. (WTP #172)

- Click here for evidence (WTP Exhibits 099-104)

2.56. Admit that the typical American family pays more in taxes than they spend on food, clothing, and housing combined. (WTP #173)

- Click here for evidence (WTP Exhibits 099-104)

2.57. Admit that there are currently over 480 tax forms. (WTP #174)

- Click here for evidence (WTP Exhibits 099-104)

2.58. Admit that the federal tax code contains over 7 million words. (WTP #175)

- Click here for evidence (WTP Exhibits 099-104)

2.59. Admit that over 1/2 of Americans are paying some sort of tax professional to help them comply with alleged tax law requirements. (WTP #176)

- Click here for evidence (WTP Exhibits 099-104)

2.60. Admit that each year the Internal Revenue Service sends out approximately 8 billion pages of tax forms and instructions, generating enough paper to stretch 28 times around the Earth. (WTP #177)

- Click here for evidence (WTP Exhibits 099-104)

2.61. Admit that Americans spend approximately 5.4 billion labor hours and $200 billion dollars per year attempting to comply with alleged tax requirements - more time and money that it takes to produce every car, truck, and van each year in the United States. (WTP #178)

- Click here for evidence (WTP Exhibits 099-104)

2.62. Admit that in 1913, the average American family had to work only until January 30th before earning enough to pay all alleged tax obligations. (See Tax Facts.) (WTP #179)

- Click here for evidence (WTP Exhibits 099-104)

2.63. Admit that the average American family had to work all the way through May 12th in order to pay their alleged federal, state, and local tax bills for the year 2000. (WTP #180)

- Click here for evidence (WTP Exhibits 099-104)

2.64. Admit that economist Daniel J. Mitchell recently observed that: "[Medieval serfs] only had to give the lord of the manor a third of their output and they were considered slaves. So what does that make us?" (See "Legalized Loot", by Machan) (WTP #181)

- Click here for evidence (WTP Exhibits 099-104)

2.65. Admit that the average Wisconsin citizen had to work until May 9th this year to pay all alleged tax obligations. (WTP #182)

- Click here for evidence (WTP Exhibits 099-104)

2.66. Admit that Americans own less of their labor than feudal serfs. (WTP #183)

- Click here for evidence (WTP Exhibits 099-104)

2.67. Admit that the 13th Amendment to the U.S. Constitution states: (WTP #184)

> *"Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction. Congress shall have power to enforce this article by appropriate legislation."*

- Click here for Thirteenth Amendment (WTP Exhibit 026)

2.68. Admit that if Congress can constitutionally tax a man's labor at the rate of 1%, then Congress is free, subject only to legislative discretion, to tax that man's labor at the rate of 100%. [Common knowledge] (WTP #185)

2.69. Admit that "peonage" is a condition of servitude compelling a man or woman to perform labor in order to pay off a debt. (WTP #186)

- Click here for *See Black's Law Dictionary, 6th Ed., West Publishing Co. 1990, p. 1135* (WTP Exhibit 106)

2.70. Admit that the Federal Reserve Act was passed in 1913, within a few months of the ratification of the Sixteenth Amendment that allegedly authorized a tax on the incomes of most Americans. (WTP #186a)

- Click here for Sixteenth Amendment

2.71. Admit that the Federal Reserve Act allowed the U.S. government to borrow large sums of money from private banking institutions at interest, and thereby potentially create a large public debt. (WTP #186b)

2.72. Admit that U.S. Congress' inability to balance the federal budget or lack of fiscal discipline could create large volumes of public debt to the Federal Reserve. (WTP #186c)

2.73. Admit that the result of increasing public debt must be an increase in income tax revenues to pay off the debt in order to maintain solvency of the federal government. (WTP #186d)

2.74. Admit that an increase in income tax revenues would require a larger percentage of the wage (labor) income of average Americans to be extracted as income tax, because more than half of federal income tax revenues derive from personal income taxes rather than corporate income taxes. (WTP #186e)

2.75. Admit that there is an incentive for politicians to buy votes with borrowed money that will be paid off by unborn children at interest. (WTP #186f)

2.76. Admit that requiring unborn children of tomorrow paying off extravagances of today at interest amounts to taxation without representation, which was the very reason our country rebelled from Great Britain to become an independent nation. (WTP #186g)

2.77. Admit that Thomas Jefferson, one of our founding fathers and author of our Declaration of Independence, said the following
(refer to http://familyguardian.tzo.com/Subjects/PoliticsLiberty/ThomasJefferson/jeffbibl.htm or http://etext.lib.virginia.edu/jefferson/quotations/jeffcont.htm for original source of quotes) (WTP #186h)

> *"I sincerely believe... that banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity under the name of funding is but swindling futurity on a large scale." --Thomas Jefferson to John Taylor, 1816. ME 15:23* Click here for original quote

> *"Funding I consider as limited, rightfully, to a redemption of the debt within the lives of a majority of the generation contracting it; every generation coming equally, by the laws of the Creator of the world, to the free possession of the earth He made for their subsistence, unencumbered by their predecessors, who, like them, were but tenants for life." --Thomas Jefferson to John Taylor, 1816. ME 15:18.* Click here for original quote

"[The natural right to be free of the debts of a previous generation is] a salutary curb on the spirit of war and indebtment, which, since the modern theory of the perpetuation of debt, has drenched the earth with blood, and crushed its inhabitants under burdens ever accumulating." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:272. Click here for original quote

"We believe--or we act as if we believed--that although an individual father cannot alienate the labor of his son, the aggregate body of fathers may alienate the labor of all their sons, of their posterity, in the aggregate, and oblige them to pay for all the enterprises, just or unjust, profitable or ruinous, into which our vices, our passions or our personal interests may lead us. But I trust that this proposition needs only to be looked at by an American to be seen in its true point of view, and that we shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves; and consequently within what may be deemed the period of a generation, or the life of the majority." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:357. Click here for original quote

"It is incumbent on every generation to pay its own debts as it goes. A principle which if acted on would save one-half the wars of the world." --Thomas Jefferson to A. L. C. Destutt de Tracy, 1820. FE 10:175. Click here for original quote

To preserve [the] independence [of the people,] we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, *or* profusion and servitude. *If we run into such debts as that we must be taxed in our meat and in our drink, in our necessaries and our comforts, in our labors and our amusements, for our callings and our creeds, as the people of England are, our people, like them, must come to labor sixteen hours in the twenty-four, give the earnings of fifteen of these to the government for their debts and daily expenses, and the sixteenth being insufficient to afford us bread, we must live, as they now do, on oatmeal and potatoes, have no time to think, no means of calling the mismanagers to account, but be glad to obtain subsistence by hiring ourselves to rivet their chains on the necks of our fellow-sufferers." --Thomas Jefferson to Samuel Kercheval, 1816. ME 15:39.* Click here for original quote

2.78. Admit that with an unlimited source of credit in the Federal Reserve, and an ability to claim any percentage of the income of the Average American in income taxes, the growth of the federal government and the smothering and complete extinguishment of liberty is inevitable given the vagaries and weaknesses of the humankind who occupy public office. (WTP #186i)

2.79. Admit that "peonage" is a form of involuntary servitude prohibited by the Thirteenth Amendment to the Constitution of the United States. (WTP #187)

- Click here for Thirteenth Amendment (WTP Exhibit 026)
- Click here for Clyatt v. United States, 197 U.S. 207 (1905) or here for online version.

2.80. Admit that the U.S. Congress abolished peonage in 1867. (WTP #188)

- See 42 U.S.C. § 1994; R.S. § 1990, Act of Mar. 2, 1867, c. 187, § 1, 14 Statute 546 (WTP Exhibit 108)

2.81. Admit that holding or returning any person to a condition of peonage is a crime under 18 U.S.C. § 1581. (WTP #189)

- Click here for 18 U.S.C. §1581 (WTP Exhibit 109)

2.82. Admit that involuntary servitude means a condition of servitude in which the victim is forced to work for another by use or threat of physical restraint or injury, or by the use or threat of coercion through law or legal process. (WTP #190)

- Click here for Clyatt v. United States, 197 U.S. 207 (1905) or here for online version. (WTP Exhibit 107)
- Click here for Bailey v. Alabama, 219 U.S. 219 (1910) or here for online version. (WTP Exhibit 110)
- Click here for United States v. Kozminski, 487 U.S. 931 (1988) or here for online version. (WTP Exhibit 111)

2.83. Admit that if an American stops turning over the fruits of his or her labor to the federal government in the form of income tax payments, he suffers under the risk of possible criminal prosecution and incarceration. (See Schiff Affidavit or Form 1040 Instruction Booklet) (WTP #191)

- Click here Form 1040 Instruction Booklet (WTP Exhibit 112)

SECTION 2-RIGHT TO LABOR SUMMARY

Our Declaration of Independence spells out the philosophical and moral basis for our form of government. Our Constitution codifies the structures and limits of that government.

It has been long held that the unalienable rights to life, liberty and the pursuit of happiness are effectively the rights of life, liberty and property. To tax any of these unalienable rights is to effectively deprive us of those rights.

This is the reason new babies cannot be "taxed" and that one cannot be forced to pay a tax to remain "free" or to pay a tax to enjoy any other protected right (e.g., to a publish a book, speak in public, assemble with your fellow citizens or transport your property down the *road [oops! – we'll get to that some other time...]*

One of the means by which IRS accomplishes its unlawful mission is to deceive us about what the definition of income is and who is actually required to pay it. The word "income" is not defined in the Internal Revenue Code.

As the evidence will show, the Supreme Court has ruled that income is defined as a gain or increase arising from *corporate* activities. People are not corporations and do not operate under via privileges extended to them by the state or federal governments. Under our system of government the People are the Sovereigns.

What emerges from the evidence are documented examples of how our government attempts to gloss over very important concepts of law and convince everyone that wages and salaries somehow are "income" that can be taxed under the law. In fact, no real gain or profit can accrue from wages and the wages themselves and in any event, do not arise from "sources" that the federal government has constitutional jurisdiction to tax.

The constitutional limitations on income taxes apply equally to the so-called FICA or payroll taxes for Social Security and Medicare.

Perhaps most troubling is the lack of distinction between our current income tax and a "slave tax", or system of "peonage" which confiscates the labor of the persons being held in involuntary servitude, which beyond morally repugnant under natural law, is now outlawed explicitly by the 13th Amendment.

The questions examine closely the problems posed by a mandatory tax on wages and the Constitution's prohibition against involuntary servitude. How can these exist simultaneously?

How can the government tax and confiscate months worth of our labor each year if they are prohibited by the Constitution from holding the People as slaves? Is this not a distinction without a difference?

Is the income tax system voluntary or not? Are we slaves or not?

A final thought:

Consider that in our form of government the People are the Sovereigns. The limited powers granted the federal government flow from the People.

But consider that for the People to grant a power to the government, they must first rightfully possess that power themselves. For instance, the People cannot grant the government true, bona fide legal authority to steal or rape because the People themselves do not possess this legal (or natural) right.

How is it then that the People have purportedly consented to convey to the U.S. government the right to effectively enslave fellow citizens when the People, in fact, have no such right to make "peons" of our fellow citizens?

Can the People morally and legally empower through vote, or Constitution a government that can unilaterally confiscate the property or labor of another natural person when the People in fact have no such legal or moral right?

Does wrapping this alleged power in millions of words in thousands of pages of “legaleze” diminish this argument? Does the majority of the many have a moral or legal authority “to vote” to confiscate the labor of the few?

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Is the Income Tax a Form of Slavery?

http://www.lewrockwell.com/yates/yates17.html

Is the Income Tax a Form of Slavery?

by Steven Yates and Ray E. Bornert II

Slavery, we are reminded incessantly these days, was a terrible thing. In today's politically correct society, some blacks are demanding reparations for slavery because their remote ancestors were slaves. Slavery is routinely used to bash the South, although the slave trade began in the North, and slavery was once practiced in every state in the Union. Today's historians assure us that the War for Southern Independence was fought primarily if not exclusively over slavery, and that by winning that war, the North put an end to the peculiar institution once and for all.

Whoa! Time out! Shouldn't we back up and ask: what is slavery? It has been a while since those ranting on the subject have offered us a working definition of it. They will all claim that we know good and well what it is; why play games with the word? But given the adage that those who can control language can control policy, it surely can't hurt to revisit the definition of slavery. There are good reasons to suspect the motives of those who won't allow their basic terms to be defined or scrutinized.

Here is a definition, one that will make sense of the instincts telling us that slavery is indeed an abomination: *slavery is non-ownership of one's Person and Labor*. It is involuntary servitude. A slave must work under a whip, real or figurative, wielded by other persons, his owners, with no say in how (or even if) his labors are compensated. His is a one-way contract he cannot opt out of. A slave is tied to his master (and to the land where he labors). He cannot simply quit if he doesn't like it. Moreover, a slave can be bought and sold like any other commodity.

In this case slavery is at odds with libertarian social ethics, in which all human beings have a natural right to ownership of Person and Labor. According to libertarian social ethics, contracts should be voluntary and not coerced. This is sufficient for us to oppose slavery with all our might. However, notice that this clear definition of slavery is a double-edged sword. There is no reference to race in the above definition. That whites enslaved blacks early in our history is an historical accident; there is nothing inherently racial about slavery. Many peoples have been enslaved in the past, including whites. The South, too, has no intrinsic connection with slavery, given how we already noted that it was practiced in the North as well. No slaves were brought into the Confederacy during its brief, five-year existence, and it is very likely that the practice would have died out in a generation or two had the Confederacy won the war.

Finally, it is clear that when most people talk about slavery, they are referring to *chattel* slavery, the overt practice of buying, selling and owning people like farm animals or beasts of burden. Are there other forms of slavery besides chattel slavery?

Before answering, let's review our definition above and contrast slavery with sovereignty, in the sense of sovereignty over one's life. Slavery, we said, is nonownership of Person and Labor. In that case, *sovereignty is ownership of Person and Labor*. The basic contrast, then, is between slavery and sovereignty, and the issue is ownership. And there are two basic things one can own: one's Person (one's life), and one's Labor (the fruits

of one's labors, including personal wealth resulting from productive labors).

Let us quantify the situation. A plantation slave owned neither himself nor the fruits of his labors. That is, he owned 0% of Person and 0% of Labor. In an ideal libertarian order, ownership of Person and Labor would be just the opposite: 100% of both. In this case, we have a method allowing us to describe other forms of slavery by ascribing different percentages of ownership to Person and Labor. For example, we might say that a prison inmate owns 5% of Person and 50% of Labor. Inmates are highly confined in person yet they are allowed to own wealth both inside the prison and outside. Some, moreover, are allowed to work at jobs for which they are paid. When slavery was abolished, ownership of Person and Labor was transferred to the slave, and he became mostly free. So let us define the following categories in terms of individual percentage ownership:

Category	**Characteristics**
Chattel Slavery	0% ownership of Person and Labor
Partial Slavery	some % ownership of Person and Labor
Perfect Liberty	100% ownership of Person and Labor

With this in mind, here is our question for our readers: *how much ownership do you have in your person and your labor?* Are you really free? Or are you a partial slave? We are not, of course, talking about arrangements that cede a portion of ownership of Person and Labor to others through voluntary contract.

We submit that forcible taxation on your personal income makes you a partial slave? For if you are legally bound to hand a certain percentage of your income (the fruits of your labors) over to federal, state and local governments, then from the legal standpoint you only have "some % ownership" of your person and labor. The pivotal point is whether or not ownership is ceded through voluntary contract. Have you any recollection of any deals you signed with the IRS promising them payment of part of your income? If not, then if 30% of your income is paid in income taxes, then you have only 70% ownership of Labor. You are a slave from January through April – a very conservative estimate at best, today!

If one wants to stand on the U.S. Constitution as one's foundation, then the 13th Amendment to the U. S. Constitution can be used as an ironclad argument against a forcible direct tax on the labor of a human being. The 13th Amendment says: "Neither slavery nor involuntary servitude, except as a punishment for a crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction. Congress shall have the power to enforce this article by appropriate legislation."

The 13th Amendment makes it very clear that we cannot legally or Constitutionally be forced into involuntary servitude.

As such, we maintain that a human being has an inalienable right to own 100 % of Person and 100% of Labor, including control over how the fruits of his actions are dispensed. A human being has an inalienable right to control the compensation for his labor while in the act of any service in the marketplace – e.g., digging ditches, flipping burgers, word-processing documents for a company, programming computers, preparing court cases, performing surgery, preaching sermons, or writing novels.

A forcible direct tax on the labor of a human being is in violation of this right as stated in the 13th Amendment. If we work 40 hours a week, and another entity forcibly conscripts 25 % of our compensation, then we argue that

we have been forced into involuntary servitude – slavery – for 10 of those 40 hours, and we were free for the other 30. If we could freely choose to work just the 30 hours and decline to work the 10 hours, then our wills would not be violated and the 13th Amendment would be honored.

However, Congress, the IRS and their Internal Revenue Code (IRC) lay direct claim to those ten hours (or some stated percentage) without our consent.

In other words, in a free and just society, a society in which there is no slavery of any form:

- Human beings are not forced to work for free, in whole or in part.
- Human beings are not slaves to anything or anyone.
- Anyone who attempts to force us to work for free, without compensation, has violated our rights under the 13th Amendment.

This, of course, is not the state of affairs in the United States of America at the turn of the millennium, in which:

- We labor involuntarily for at least four months out of every year for the government.
- We are, therefore, slaves for that period of time.
- The government, having forced us to work for free, without compensation, has violated the 13th Amendment.

Of course, what follows from all this discussion is that there is an issue about slavery. But it is not the issue politically correct historians and activists are raising. As for reparations, we suspect many of us might be willing to let bygones be bygones if we never had to pay out another dime to the IRS. We often read about how great the economy is supposedly doing. Just imagine how it would flourish if human beings owned 100% of Person and Labor, and could voluntarily invest the capital we currently pay to the government in our businesses, our homes, our schools, and our communities!

For those of you who believe that the 16th Amendment repealed, replaced, modified, appended, amended or superceded the 13th Amendment, you are mistaken. For an Amendment to be changed, in any way, there must be an Amendment that emphatically declares this action. There is absolutely nothing in the Constitution that alters the efficacy of the 13th Amendment in even the slightest way. The 16th merely allowed the government to enter the "National Social Benefits" business where it finances the system with the mandatory contributions of voluntary participants. While all Americans certainly understand the concept of mandatory contributions, they fail to understand the concept of voluntary participation, largely due to a very effective marketing campaign on the part of our central government for several generations now since the Great Depression. The 16th gave

the government the power to legally enter a contractual relationship with its citizens wherein the citizen contributes a portion of his labor in exchange for social benefits. In order for both Amendments to peacefully coexist, the contractual relationships in the system created by the 16th cannot be forced upon the citizens. For to do so would be to contradict the 13th completely.

Two final questions, and a few final thoughts. Can we really take seriously the carpings of politically correct historians about an arrangement (chattel slavery) that hasn't existed for 140 years when they completely ignore the structurally similar arrangements (tax slavery) that have existed right under their noses during most of the years since. And does a governmental system which systematically violates its own founding documents, and then oversees the imprisoning of those who refuse to recognize the legitimacy of the violations, really have a claim on the loyalty of those who would be loyal to the ideals represented in those founding documents?

Eventually, we have to make a decision. How long are we going to continue to put up with the present arrangements? In the Declaration of Independence is found these remarks: "... [a]nd accordingly all Experience hath shewn, that Mankind are more disposed to suffer, while Evils are sufferable, than to right themselves by abolishing the Forms to which they are accustomed." We are accustomed to the income tax. Most people take it for granted, and don't look at fundamental issues. Yet some have indeed opted out of the tax system. It is necessary, at present, to become self-employed and hire oneself out based on a negotiated contract in which you determine your hourly rate and then bill for your time. Then you send your client an invoice, they write a check directly to you in response, and you take the check and deposit it in your bank account; you may wish to open a bank account with a name like John Smith Enterprises DBA (DBA stands for 'Doing Business As'). If the bank asks for a tax-ID number, you may give your social security number. This is perfectly legal since you are not a corporation nor are you required to be. Nor does the use of a government issued number contractually obligate you to participate in their system.

We should specify here that we are discussing taxes on income resulting from personal labor, to be carefully distinguished from taxes for the sale of material items, or excise taxes. These are an entirely separate matter.

By advocating opting out of the tax slavery system, we are not advocating anything illegal here; that is the most surprising thing of all. The Treasury Department nailed Al Capone not because of failure to pay taxes on his personal labor but for his failure to pay the excise tax on the sale of alcoholic beverages. So a plan to be self-employed that includes profit from the sale of material goods should include a plan to pay all the excise taxes; you risk a prison sentence if you don't. But the 13th Amendment directly prohibits anything or anyone from conscripting your person or the fruits of your physical or cognitive labors; to do so is make a slave of you. You may, of course, voluntarily participate in the SSA-W2 system by free choice. In this case you are required to submit to the rules as outlined in the Internal Revenue Code (IRC). And this means that you will contribute a significant fraction of your labor to pay for the group benefits of the system in which you are voluntarily participating.

Your relationship with the system technically begins with the assignment of a Social Security Number (Personal Tax ID Number). This government-issued number, however, does not contractually obligate you to anything. The government cannot conscript its citizens simply by assigning a number to them. Assigning the number is perfectly fine. But conscripting them in the process is a serious no-no. Some people that feel strongly about the last chapters of the book of Revelation might view this as pure – evil.

The critical point in the relationship begins when a citizen accepts a job with an IRS registered corporation. Accepting the government owned SSA-W2 job marries you to the system. The payroll department has the employee fill out a W4. This W4 officially notifies the employee that the job in question is officially part of the SSA-W2 system and that all job-income is subject first to the rules and regulations of the IRC and then secondly to the employee. When you sign that W4 you are at that point very, very married to the system.

So why not just decline to sign the W4?

You can decline to sign a W4 but this does not accomplish much nor does it unmarry you from the system. Your payroll office will merely use the IRC defaults already present in the payroll software and all deductions will be based on those parameters.

Okay, you might say, fine, I'll sign a W4 but I'll direct my payroll department to withhold zero. (You can do this for federal withholding but not for social security tax.) This still does not unmarry you from the system. Your payroll department still reports the gross income and deductions for your SSA-W2 job to the IRS each and every quarter. And at the end of the year you will probably end up writing a large check to the IRS for the group contributions you declined to pay during the year.

You then might say, Okay, then I'll just direct my payroll office to decline to report income to the IRS.

Reply: they cannot legally decline to report your SSA-W2 income because of their contractual obligations under the IRC that were agreed to when they established their official IRS registered corporation. The corporation can get into deep trouble by violating their contract.

Okay, you reply in turn, I'll just get the corporation to create a non-SSA-W2 job for me.

Response this time: the corporation cannot do this either; their contract under the IRC requires every single employee-job in that corporation to be an SSA-W2 job. This is similar to labor union practices of insisting that all jobs in a plant be union jobs.

You retort: isn't this a government monopoly on every corporate job in America???

The short answer is YES.

So how can I legally decline to work for free?

The answer is to decline to be an 'employee' of an official IRS registered corporation.

How is that possible?

The answer is simple. You become an independent contractor. The Supreme Court upholds the sovereignty of the individual and has declared that your "...power to contract is unlimited." Corporations hire the labors of non-employees each and every day.

If there is an infestation of cockroaches near the employee break-room, the corporation doesn't create an SSA-W2 employee exterminator job. They hire a contract exterminator to kill the bugs. When the bug-man arrives they don't hand him a W4 and ask him to declare his allowances, they lead him straight to the big-fat-ugly

roaches and implore him to vanquish the vermin immediately. When the bug-man finishes the job he hands them an invoice for his services. And the company sends him a check to pay the invoice. And nowhere on that check will you find a federal, state, county or city withholding deduction or a social security deduction or a medical or dental deduction or a garnishment or an "I'll-be-needing-an-accountant-to-figure-all-this-out" deduction or a "Tuesday-Save-The-Turnips-Tax" deduction. On the contrary, the bug-man receives full remuneration for his service. This simple arrangement is completely legal and the IRC has zero contractual claim to any part of this check (assuming the bug-man has made no contract under the IRC). And anyone or anything that attempts to forcibly conscript any part of that check is violating the bug-man's rights under the 13th Amendment.

SUPREME COURT RULING ON INDIVIDUAL SOVEREIGNTY

"There is a clear distinction in this particular case between an individual and a corporation, and that the latter has no right to refuse to submit its books and papers for an examination at the suit of the State. The individual may stand upon his constitutional rights as a citizen. He is entitled to carry on his private business in his own way. His power to contract is unlimited. He owes no such duty to the State, since he receives nothing therefrom, beyond the protection of his life and property. His rights are such as existed by the law of the land long antecedent to the organization of the State, and can only be taken from him by due process of law, and in accordance with the constitution. Among his rights are a refusal to incriminate himself, and the immunity of himself and his property from arrest or seizure except under a warrant of the law. He owes nothing to the public so long as he does not trespass upon their rights." Hale v. Henkel, 201 U.S. 43 at 47 (1905).

What does the bug-man do with his check?

The short answer is ... he keeps it ... all of it.

What about filing a tax return?

The bug-man declines to file a return since he has nothing to report that is under the jurisdiction of the IRC. Since he does not work in a government owned SSA-W2 job he is out of the system and under no contractual obligation to make contributions. The corporation that wrote him a check for his service legally reports it as an internal business expense. He is legally classified as a non-participant.

If you are in the SSA-W2 system:

The purpose of an individual year-end tax-return is to settle the exact amount of contractually required contributions to the SSA-W2 system as determined by the IRC. Filing is purely voluntary. You can decline to file but doing so does not release you from your contractual obligations under the IRC. In the absence of a tax-return, the IRC permits the IRS to file a tax-return on your behalf and they are allowed to file a return that maximally favors them. And this they will do if it creates a receivable – accounting lingo for – "you owe them money." They will decline to file a return if it would create a payable – accounting lingo for "they owe you money." If the IRS files a return and creates a receivable against you they will send you a notice declaring their claim. If you decline to pay, the IRC permits the IRS to file a tax-lien against you. This of course will be seen on your credit report. And the end result is your credit is damaged. The IRS computers will see to it that the lien remains on your credit report until the lien is paid. You can't beat a computer.

What if I file a return but cheat like crazy?

This is a very bad idea. The Treasury Department nailed Leona Helmsley not because she failed to pay taxes on her personal labor but because she filed a fraudulent tax return. Filing a dishonest tax return puts you at risk. The IRS is very astute at defending itself. Basically the IRS is responsible for enforcing the IRC rules. If you are in the SSA-W2 system you have to live by the IRC. If you decide to stay in the system, we recommend securing the services of a highly qualified CPA or tax attorney that can assist you in filing the most advantageous return possible without committing fraud or risking an audit.

In the end, the law does allow you to opt-out because you can't be forced to work for free. If you do opt-out there are at least 2 potential inconveniences you need to understand:

1) Difficulty with conventional loans.

You will have a far more difficult time getting loans from conventional banks, because so often these depend on verifying your income with signed tax returns you no longer have. You can hire an accountant to compose a certified financial statement that some loan institutions may accept as valid proof of income.

2) No unemployment benefits.

This benefit is part of the SSA-W2 system and since you're not in the system you can't use the benefits. If you have no contracts you only have yourself to complain to, you can't complain to the government because you can't get anyone to do business with you.

Moreover, some who have opted out have moved all their physical assets into a trust. This measure makes it almost impossible for the IRS to touch the assets. The IRS, after all, cannot simply decide to go after a person's wealth. They have to obey IRC rules as well. If there is no income over which they have jurisdiction then they can legally do nothing.

It is worth noting, finally, that the government is in the "National Social Benefits" business. The government entered this business with the ratification of the 16th Amendment and has achieved a near perfect monopoly in this market (a violation of anti-trust laws). If you don't believe this, try finding a non-SSA-W2 job with a U.S. corporation. As such, it is in the interest of any business that has a monopoly to get the customers to believe that there is no alternative to the present business relationship. The government is not about to provide any of its customers (you and I) with any information suggesting otherwise. In obtaining such information, we are clearly on our own; no government agency will assist you in opting out of the income tax system or the social security system, with the possible exception of the U.S. Supreme Court, should the right case one day come before them.

So one's best weapon is still the Declaration of Independence, the U.S. Constitution, the 13th Amendment, and information. Whatever the inconveniences, the reward is personal sovereignty – otherwise known as freedom.

October 7, 2000

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Sovereignty Education and Defense Ministry (SEDM)
FORM INDEX

TABLE OF CONTENTS:

1. **SEQUENTIAL CATEGORIZED INDEX OF SEDM FORMS**
   - 1 General
   - 2 Affidavits
   - 3 Discovery
   - 4. Tax withholding, collection, and reporting
   - 5. Memorandums of Law
   - 6. Emancipation
   - 7. Response Letters
     - 7.1 General
     - 7.2 Federal
     - 7.3 State
2. **SITUATIONAL INDEX OF FORMS**
   - 2.1 Applying for a job and dealing with employers
   - 2.2 Changing your citizenship and domicile with state and federal governments
   - 2.3 General purpose
   - 2.4 Litigation
   - 2.5 Opening financial accounts or making investments without withholding or a number
   - 2.6 Responding to federal and state collection notices
   - 2.7 Withdrawing cash from financial institutions
   - 2.8 Quitting Social Security and Functioning Without an SSN
3. **ELECTRONIC FORMS COMPILATIONS**
4. **OTHER FORMS SITES**
   - 4.1 General Forms
   - 4.2 Tax Forms
   - 4.3 Legal Forms

This page contains a listing of all the free forms available on our website that may prove useful in various situations relating to sovereignty and taxes. The forms are arranged either by form number or by their use, to make finding them easier. The forms are provided in Adobe Acrobat format and may be viewed by downloading and installing the latest FREE Adobe Acrobat Reader from the link below:

http://www.adobe.com/products/acrobat/readstep2.html

Most of our forms are also FILLABLE from within the Acrobat Reader as well! Simply click on the fill-in box provided for each field, fill in the data, and save your copy of the form as a completed template. Then you can reuse the completed form again in the future so as to save you time in responding to tax collection notices. This is a very handy feature.

1. SEQUENTIAL CATEGORIZED INDEX OF SEDM FORMS

Section 5, the Memorandums of Law section, contains memorandums of law that you can attach to your pleadings and correspondence with opposing counsel during a legal dispute. Most of these memorandums of law end with a series of admissions relating to the subjects discussed in the memorandum, making them ideal for use as a discovery device during litigation as well.

Form #	Format	Title	Circumstances where used	Related Resources/Information	Date of Last Revision
1. GENERAL					
01.001	PDF	SEDM Articles of Mission	Our Mission Statement		11/29/2005
01.002	PDF	SEDM Member Agreement	Use this form to join the organization. You cannot use or view or obtain our materials without being a Member.	Member Agreement	11/11/2005
01.003	PDF	Fax Cover Sheet	Use this sheet to record your questions for comments to SEDM and then fax it to us.		4/13/2005
01.004	PDF	Famous Quotes about Rights and Liberty	Useful on any occasion		10/25/2005
01.005	HTML	Proof of Mailing	Useful to provide proof of what you mailed and when. OFFSITE LINK		10/15/2005
2. AFFIDAVITS					
02.001	PDF	Affidavit of Citizenship, Domicile, and Tax Status	Attach to an application for a financial account or job withholding form. Establishes and explains your status as a "national" and not a "citizen" under federal law.	1. Why you are a "national" or a "state national" and not a "U.S. citizen" 2. Why "domicile" and income taxes are voluntary	4/12/2006
02.002	PDF	Affidavit of Material Facts	Use this enclosure with a state response letter to establish citizenship and taxpayer status in a narrative format. Includes check marks in front of each item so that it can be reused again and made into a "Notice of Default" against a tax collection agency.	1. Federal Response Letters 2. State Response Letters	9/25/2005
02.003	PDF	Affidavit of Duress: Member Deposition	Members may use this if government attempts to compel them to attend a deposition which might either incriminate them or the SEDM ministry.		10/13/2006
02.004	PDF	Affidavit of Corporate Denial	Use this form to remove or destroy the jurisdiction of federal courts and the IRS to enforce any federal law against you.	1. Federal Jurisdiction 2. Why your Government is Either A Thief or You Are a Federal Employee for Federal Income Tax Purposes	1/29/2006
3. DISCOVERY					
03.001	ZIP file	Amplified Deposition Transcript	Use this transcript as a way to provide an amplified deposition transcript if the opposing U.S. Attorney insists that you did not answer some of the questions at a previous deposition. Scan in the original transcript, convert to text, and past into chapter 4 of this document.		2/20/2006
03.002	HTML	Handling and Getting a Due Process Hearing	This article shows how to fill out IRS form 12153 to maximize your chances of getting an in-person due process hearing.		NA
03.003	PDF	Admissions relating to alleged liability	Use this in your response to IRS notices as a way to establish what your liability is. Can be used in conjunction with Form 0001 above.	Master File Decoder Correcting Erroneous IRS form W-2's	9/30/2005
03.004	PDF	Deposition Agreement	Use this agreement when the government is attempting to depose an SEDM member. It ensures a fair hearing and equal opportunity to ask questions or each other.	Member Agreement (requires use of this form)	4/12/2006
03.005	PDF	Deposition Handout	Members may use this form to give to any government attorney or employee who has subpoenad them to give oral testimony under Federal Rule of Civil Procedure Rule 30 in relation to their involvement in this Ministry.	Federal Rule of Civil Procedure Rule 30 (OFFSITE LINK)	4/12/2006
03.006	PDF	SSA Form SSA-L996: Social Security Number Request for Extract or Photocopy	Use this form to obtain a copy of any Social Security records that the SSA is maintaining connected to your all caps name.	1. Socialism: The new American Civil Religion 2. Social Security: Mark of the Beast (OFFSITE LINK)	4/12/2006
03.007	PDF	Bureau of Public Debt FOIA	Use this form to obtain records of public debt issued in the name of an SSN, TIN, or SS Card Number. This constitutes proof that your application to SSA makes you into surety for federal debt.		11/17/2006
03.008	PDF	IRS Due Process Meeting Handout	Mail this form in advance of an IRS Audit or meeting and demand proof of authority on the record from the agent. Also bring it along with you to the due process meeting and demand that proof of jurisdiction be provided on the record using this form.	Nontaxpayer's Audit Defense Manual	12/13/2006
4. TAX WITHHOLDING, COLLECTION, AND REPORTING *(Please read Federal and State Tax Withholding Options for Private Employers)*					
04.001	HTML	IRS form W-8BEN	Provide to financial institutions and private employers to stop withholding and reporting of earnings.	About IRS form W-8BEN	4/13/2005
04.002	HTML	IRS form 56	Send this in to change your IRS status so that you aren't a fiduciary for an artificial entity or business	About IRS form 56	4/13/2005
04.003	HTML	IRS form 1098	Send in a corrected version of this report to zero out erroneous reports of mortgage interest payments "effectively connected with a trade or business".	Correcting Erroneous IRS form 1098's	4/13/2005
04.004	HTML	IRS form 1099	Send in a corrected version of this report to zero out erroneous reports of income "effectively connected with a trade or business".	Correcting Erroneous IRS form 1099's	4/13/2005
04.005	HTML	IRS form W-2	Send in to correct erroneous W-2 reports sent in by private employs with whom you have a W-8 on file and/or did not authorize withholding.	Correcting Erroneous IRS form W-2's	4/13/2005

04.006	PDF	Demand for Verified Evidence of "Trade or Business" Activity: Information Return	Use this form in the case where someone you work for or with is trying wants to fill out an Information Return against you, and you are not engaged in a "trade or business". This prevents you from having false or erroneous Information Returns filed against you by educating companies and financial institutions about their proper use.	The "Trade or Business" Scam	3/17/2006
04.007	PDF	Certification of Federally Privileged Status	Use this form with your private employer to get certification that you are not a federal "employee" or privileged "public official"	The "Trade or Business" Scam	3/17/2006
04.008	PDF	Demand for Verified Evidence of "Trade or Business" Activity: Currency Transaction Report (CTR)	Use this form in the case where you are trying to withdraw $10,000 or more from a financial institution in cash, and they want to fill out a Currency Transaction Report (CTR), Treasury form 8300, on the transaction. Typically, banks are not subject to federal legislative jurisdiction AND the CTR's can only be completed on those who are engaged in a "trade or business", which few Americans are.	The "Trade or Business" scam	1/23/2006
04.009	PDF	Tax Withholding and Reporting: What the Law Says	Present this form to private companies who you work for as a private employee, in order to educate them about what the law requires in the case of payroll withholding.	1. Federal and State Withholding Options for Private Employers (OFFSITE LINK) 2. Federal Tax Withholding	4/30/2006
04.010	PDF	IRS Form 1042	Send in a corrected version of this report to zero out erroneous reports of gross income for those nonresident aliens who are not engaged in a "trade or business".	Correcting Erroneous IRS form 1042's	11/15/2006
04.011	PDF	IRS Form 1098 Lender Letter	Send this form to lenders and mortgage companies who are wrongfully filing IRS form 1098's against you as a nonresident alien not engaged in a "trade or business" to get them to stop filing the false reports so that you don't have to correct them later.	Correcting Erroneous IRS form 1098's	11/15/2006
5. MEMORANDUMS OF LAW					
05.001	PDF	The Trade or Business Scam	Attach to your letters and correspondence to explain why you have no reportable income	1. Demand for Verified Evidence of Trade or Business Activity: CTR 2. Demand for Verified Evidence of Trade or Business Activity: Information Return	9/4/2006
05.002	PDF	Why Domicile and Income Taxes are Voluntary	Attach to your letters and correspondence to explain why you have no reportable income	Sovereignty Forms and Instructions: Cites by Topic, "Domicile" (OFFSITE LINK)	10/9/2005
05.003	PDF	Requirement for Consent	Attach to your letters and correspondence to explain why you aren't obligated to follow the I.R.C. because it isn't "law" for you	Declaration of Independence (OFFSITE LINK)	9/6/2006
05.004	PDF	Political Jurisdiction	Attach to legal pleadings in order to ensure that the court does not challenge or undermine your choice of citizenship or domicile. Establishes that any court which attempts to do this is involving itself in "political questions", which is a violation of the separation of powers doctrine.		9/25/2006
05.005	PDF	Federal Tax Withholding	For use in those seeking new employment or who wish to terminate employment tax withholding. Use in conjunction with the *Federal and State Tax Withholding Options for Private Employers* book. This is an abbreviated version of what appears in chapter 16 for management types who have little patience and a short attention span, which is most bosses.	Federal and State Tax Withholding Options for Private Employers (OFFSITE LINK) Income Tax Withholding and Reporting	3/23/2006
05.006	PDF	Why you are a "national" or "state national" and not a "U.S. citizen"	For use in obtaining a passport, for job applications, and to attach to court pleadings in which you are declaring yourself to be a "national" and a "nonresident alien".	Citizenship and Sovereignty Seminar Developing Evidence of Citizenship Seminar	8/23/2006
05.007	PDF	Reasonable Belief About Tax Liability	For use by those: 1. Establishing a reasonable belief about liability. 2. Corresponding with the IRS. 3. Being criminally prosecuted for failure to file or tax evasion.	Great IRS Hoax Federal and State Tax Withholding Options for Private Employers (OFFSITE LINK)	9/6/2006
05.008	PDF	Why Your Government is Either A Thief or You are a "Public Official" for Income Tax Purposes	Use this as an attachment to prove why Subtitle A of the Internal Revenue Code, in context of employment withholding and earnings on a 1040, are connected mainly with federal employment.		3/23/2006
05.009	PDF	Legal Requirement to File Federal Income Tax Returns	Use this as an attachment in response to a CP-518 IRS letter, or as part of a brief in response to criminal prosecution for "Willful Failure to File" under 26 USC §7203.	Reasonable Belief About Tax Liability	3/4/2006
05.010	PDF	Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents	Use this as an attachment in response to an IRS penalty collection notice to prove that you aren't responsible to pay the assessed penalty. Make sure you also follow the guidelines relating to SSNs in our article entitled "About SSNs/ TINs on Tax Correspondence"	26 U.S.C. §6671(b) (OFFSITE LINK) Sovereignty Forms and Instructions, Cites by Topic, "Bill of Attainder" (OFFSITE LINK)	1/26/2006
05.011	PDF	Why Assessments and Substitute for Returns are Illegal Under the I.R.C. Against Natural Persons	Use this as an attachment in response to an IRS or state "Notice of Proposed Assessment" or 90-day letter to show that the proposed assessment is illegal. Make sure you also attach IRS form 4852's and corrected 1099's to zero out illegal reports of taxable income using the links provided at the beginning of the memorandum.	Sovereignty Forms and Instructions, Cites by Topic, "assessments" (OFFSITE LINK)	1/8/2006

05.012	PDF	About SSNs and TINs on Government Forms and Correspondence	Use this form whenever you are filling out paperwork that asks for an SSN and the recipient won't accept the paperwork because you said "None" on the SSN block. The questions at the end will stop all such frivolous challenges by recipients of the forms you submit, if they have even half a brain.	Wrong Party Notice About IRS form W-8BEN	3/4/2006
05.013	PDF	Who are "taxpayers" and who Needs a "Taxpayer Identification Number"?	Attach this to financial account applications, job applications, etc. Shows why you don't need SSNs or TINs on government correspondence.	"Taxpayer" v. "Nontaxpayer", Which One are You? (OFFSITE LINK)	10/9/2005
05.014	PDF	The Meaning of the Words "includes" and "including"	Rebuttal to the most popular IRS lie and deception. Attach to response letters or legal pleading.	1. Rebutted Version of IRS The Truth About Frivolous Tax Arguments 2. Statutory Interpretation: General Principles and Recent Trends (OFFSITE LINK)	10/8/2006
05.015	PDF	Commercial Speech	Helpful to those facing injunctions.	Freedom of Speech and Press: Exceptions to the First Amendment (OFFSITE LINK)	7/24/2006
05.016	PDF	Socialism: The New American Civil Religion	Proves that government has become a false god and an idol in modern society in violation of the First Amendment.	1. Family Guardian: Communism and Socialism (OFFSITE LINK) 2. Social Security: Mark of the Beast (OFFSITE LINK) 3. The Law (OFFSITE LINK)	7/29/2006
05.017	PDF	Presumption: Chief Weapon for Unlawfully Enlarging Federal Jurisdiction	Explains how federal agencies, courts, and the law profession unlawfully use "presumption" as a means to enlarge federal or government jurisdiction.	Sovereignty Forms and Instructions, Cites by Topic, "presumption" (OFFSITE LINK)	6/30/2006
05.018	PDF	Federal Jurisdiction	Explains choice of law in deciding federal jurisdiction in the context of federal income tax trials.		9/25/2006
05.019	PDF	Court Sanctions, Contempts, and Defaults	Describes circumstances under which court sanctions and contempt of court may lawfully be imposed in federal court.	1. Federal Rule of Civil Procedure Rule 11 (OFFSITE LINK) 2. Federal Rule of Civil Procedure Rule 37(b) (OFFSITE LINK)	2/17/2006
05.020	PDF	Nonresident Alien Position	Describes and defends the Nonresident Alien Position that is the foundation of this website.	About IRS Form W-8BEN	10/26/2006
05.021	PDF	Silence as a Weapon and a Defense in Legal Discovery	Describes how to use your constitutional rights to prevent incriminating yourself or prejudicing your Constitutional rights. Also describes how to respond to such tactic.	Federal Rule of Civil Procedure Rule 8(d) (OFFSITE LINK)	7/17/2006
05.022	PDF	Requirement for Reasonable Notice	Describes the requirement for reasonable notice and how you can find out what laws you are required to obey based on how they are noticed by the government.	Federal Register Act (OFFSITE LINK) Administrative Procedures Act (OFFSITE LINK)	8/15/2006
05.023	PDF	Government Conspiracy to Destroy the Separation of Powers	Describes historical efforts by the government to break down the separation of powers and destroy our God-given rights.	Separation of Powers Doctrine	9/5/2006
05.024	PDF	Apostille of Documents	Describes how to get your documents apostilled by the Secretary of State of your State for international use. This is useful for form 06.005 below.	State legal resources (OFFSITE LINK. find a state secretary of state)	8/18/2006
05.025	PDF	Government Burden of Proof	Describes the burden of proof imposed upon the government whenever enforcement actions are employed.		8/28/2006
05.026	PDF	How the Government Defrauds You Out of Legitimate Deductions for the Market Value of Your Labor	Describes how to lawfully and legally deduct the entire market value of your labor from your earnings on a federal or state tax return.	Is the Income Tax a Form of Slavery? (OFFSITE LINK)	10/14/2006
05.027	PDF	Meaning of the word "Frivolous"	Describes the meaning of the word "frivolous", how it is abused by the government and legal profession, and how to prevent such abuses		10/3/2006
05.028	PDF	Laws of the Bible	Index and authorities on all the moral laws of the Bible, and how to apply them to the practical affairs of daily secular life.	Holy Bible (OFFSITE LINK)	10/13/2006
05.029	PDF	Unlicensed Practice of Law	Those wishing to lawfully help or assist others in the practice of law, including in arguing before courts of law, may attach this to Litigation Tool 3.003 in order to prove that they have authority to do so.	Litigation Tool 3.003: Motion for Non-Bar Counsel	12/14/2006
6. EMANCIPATION					
06.001	PDF	Why You Aren't Eligible for Social Security	Use this form to apply for a driver's license without a Slave Surveillance Number. Most states require applications who are eligible for Social Security to provide a number. This pamphlet proves you aren't eligible and therefore don't need one.	Social Security: Mark of the Beast (OFFSITE LINK)	9/22/2005
06.002	PDF	Resignation of Compelled Social Security Trustee	Allows a person to legally and permanently quit Social Security. Used with permission from original author.	1. Social Security: Mark of the Beast (OFFSITE LINK) 2. Socialism: The New American Civil Religion 3. About IRS form 56	9/24/2005
06.003	PDF	Sovereignty Forms and Instructions Book	Free forms and instructions which help you achieve and defend personal sovereignty and the sovereignty of God in the practical affairs of your life. Also available in online version. This is an OFFSITE resource and we are not responsible for the content.	Online version of this book (OFFSITE LINK)	2/21/2006
06.004	PDF	Enumeration of Inalienable Rights	Use this form to litigate in court to defend your rights. Gives you standing without the need to quote federal statutes that you are not subject to anyway as a nonresident alien.	Constitution Annotated	4/24/2006

06.005	ZIP	Legal Notice of Change in Domicile/ Citizenship Records and Divorce from the United States	This form completely divorces the government and changes your status to that of a "stateless person" and a "transient foreigner" not subject to civil court jurisdiction and a "nontaxpayer". After filing this form, you can also use it to rebut tax collection notices.	1. Why you are a "national" or a "state national" and not a "U.S. citizen" 2. Why Domicile and Income Taxes are Voluntary	8/6/2006
7. RESPONSE LETTERS					
7.1 GENERAL					
07.011	PDF	Payment Delinquency and Copyright Violation Notice	Use this form to respond to state or federal tax collection notices. It can be used in connection with the Change of Address Attachment Affidavit.		9/8/2005
07.012	PDF	Wrong Party Notice	Send this notice if the state or IRS collection notice you received was delivered to a person with an all caps name or with any kind of identifying number.	About SSNs and TINs on Government Forms and Correspondence	10/4/2005
07.013	PDF	1098 Interest: Request for Filing Response	Send this form attached to a letter in which you respond to a state or IRS notice requesting you to file based on their receipt of an IRS form 1098, which is the form used by mortgage companies to report receipt of payments on a mortgage.	The "trade or business" scam	1/20/2006
07.014	PDF	Legal notice to cease and desist illegal enforcement activities	Use this form to officially notify the government collection agency that they are engaging in unlawful activity, are personally liable, and may not impose any provision of law against you without first proving you are a "taxpayer" with other than information hearsay returns.		8/1/2006
07.015	PDF	Third Party Tax Debt Collector Attachment	Use this form as an attachment to any correspondence you send a private debt collector in connection with any tax collection activity they are undertaking against you.		11/1/2006
7.2 FEDERAL					
07.021	PDF	Demand for Verified Evidence of Lawful Federal Assessment	Used in response to an IRS collection notice to request verified evidence validating the assessment connected to the amounts alleged to be owed.	1. Master File Decoder 2. Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents	4/12/2006
07.022	PDF	Assessment Response: Federal	Systematic way to respond to a federal penalty or tax assessment notice that is improper or illegal.	1. Why Assessments and Substitute for Returns are Illegal Under the I.R.C. Against Natural Persons 2. Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents	7/28/2006
07.023	PDF	Substitute for Federal Form 1040NR	Use this to respond to an IRS demand for a return to be filed.		10/5/2006
7.3 STATE					
07.031	PDF	Demand for Verified Evidence of Lawful State Assessment	Used in response to an State collection notice to request verified evidence validating the assessment connected to the amounts alleged to be owed.	1. Master File Decoder 2. Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents	4/12/2006
07.032	PDF	Assessment Response: State	Systematic way to respond to a state penalty or tax assessment notice that is improper or illegal.	1. Why Assessments and Substitute for Returns are Illegal Under the I.R.C. Against Natural Persons 2. Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents	4/13/2006
07.033	PDF	Substitute for State Nonresident Tax Return	Use this to respond to a state demand for a return to be filed.		8/11/2006

2. SITUATIONAL INDEX OF FORMS

Locate the situation you are in and then find forms relative to that specific situation in the subsections below. For further information pertinent to each situation, see:

- Our Situational References Page in the Liberty University, item 5.1.
- Subject Index (OFFSITE LINK)- Family Guardian

2.1. Applying for a job and Dealing with Employers

About IRS form W-8BEN: FORM 04.001 - this is the ONLY withholding form a nontaxpayer can use. The W-4 leads to BIG trouble and violation of law
Affidavit of Citizenship, Domicile, and Tax Status: FORM 02.001
Demand for Verified Evidence of "Trade or Business" Activity: Information Return: FORM 04.006- Use this form in the case where someone you work for or with may or definitely will file a fraudulent Information Return against you, and you are not engaged in a "trade or business". This prevents you from having false or erroneous Information Returns filed against you by educating companies and financial institutions about their proper use. Information Returns include

Federal Forms W-2, 1042-S, 1098, and 1099.
Federal Tax Withholding: FORM 05.005-brief pamphlet to hand to private employer to educate him about his withholding duties
Federal and State Withholding Options for Private Employers-lots of useful forms at the end of the document. Mainly for employees. Too long and may scare away private employers. Section 23.13, FORM 13 in that book is very useful to attach to your job application
Letter to Government Employer Stopping Withholding (OFFSITE LINK)
Letter to Commercial Employer Stopping Withholding (OFFSITE LINK)
Payroll Withholding Attachment (OFFSITE LINK)
Substitute IRS Form W-8BEN (OFFSITE LINK)
Who are "taxpayers" and who needs a "Taxpayer Identification Number": FORM 05.013 - short pamphlet you can attach to a job application to prove that you don't need to deduct or withhold and aren't a "taxpayer"

2.2. Changing your Citizenship and Domicile with State and Federal Governments

Change of Address Form Attachment (OFFSITE LINK)
Legal Notice of Change in Domicile/Citizenship Records and Divorce from the United States (OFFSITE LINK)
Passport Amendment Request (OFFSITE LINK)
Voter Registration Attachment (OFFSITE LINK)

2.3. General purpose

Attachment to Government Form that Asks for Social Security Number (OFFSITE LINK)
Famous Quotes About Rights and Liberty: FORM 01.003
Proof of Mailing: FORM 01.005 (OFFSITE LINK)
SEDM Fax Cover Sheet: FORM 01.004
SEDM Member Agreement: FORM 01.001

2.4. Litigation

SEDM Litigation Tools Page, Section 2

2.5. Opening financial accounts or making investments without withholding or a number

About SSNs/TINs on Government Forms and Correspondence: FORM 05.012- attach to account application to prove why you don't need a number
Affidavit of Citizenship, Domicile, and Tax Status: FORM 02.001
IRS Form W-8BEN: FORM 04.001
IRA Rollover Attachment (OFFSITE LINK)
Letter to remove SSN and tax withholding from account (OFFSITE LINK)
Legal Address Inquiry Letter Response (OFFSITE LINK)
Substitute IRS Form W-9 (OFFSITE LINK)
Who are "taxpayers" and who needs a "Taxpayer Identification Number": FORM 05.013-attach to account application to prove why you don't need a number

2.6. Responding to federal and state collection notices

Federal letter and notice index -index of all federal tax collection notices and letters and their responses
State letter and notice index - index of all state tax collection notices and letters and their reponses
Admissions relating to alleged liability: FORM 03.004
Affidavit of Material Facts: FORM 02.002
Demand for Verified Evidence of Lawful Federal Assessment: FORM 03.001

Demand for Verified Evidence of Lawful State Assessment: FORM 03.002
IRS Form W-8BEN: FORM 04.001
IRS Form 4852: FORM 04.002
IRS Form 1098: FORM 04.003
IRS Form 1099: FORM 04.004
IRS Form 56: FORM 04.004
Legal Requirement to File Federal Income Tax Returns: FORM 05.009
Test for Federal Tax Professionals (OFFSITE LINK)
Test for State Tax Professionals (OFFSITE LINK)
The Meaning of the Words "includes" and "including": FORM 05.014 - attach responses to prove the IRS is lying about the use of the word "includes" in determining the meaning of definitions within the I.R.C.
Who are "taxpayers" and who needs a "Taxpayer Identification Number": FORM 05.013-attach to account application to prove why you don't need a number
Why Penalties are Illegal for Anything But Federal Employees, Contractors, and Agents: FORM 05.010
Why Assessments and Substitute for Returns are Illegal Under the I.R.C. Against Natural Persons: FORM 05.011
Writing Effective Response Letters-SEDM article
Wrong Party Notice: FORM 07.002 - use this form to explain why the TIN or SSN or the name on a collection notice are wrong. IRS cannot use any SSN, TIN, or all caps name to address you without assuming that you are a federal "employee"

2.7. Withdrawing cash from financial institutions

Demand for Verified Evidence of "Trade or Business" Activity: CTR: FORM 03.003 -use this if they try to violate the law by preparing a Currency Transaction Report for your withdrawal

2.8. Quitting Social Security and Functioning Without an SSN

Resignation of Compelled Social Security Trustee: FORM 06.002 - quit Social Security completely and get all your money back
Why You Aren't Eligible for Social Security: FORM 06.001 -use this to get a state driver's license without a Social Security Number
Wrong Party Notice: FORM 07.002 - use this form to explain why the TIN or SSN or the name on a collection notice are wrong. IRS cannot use any SSN, TIN, or all caps name to address you without assuming that you are a federal "employee"

3. ELECTRONIC FORMS COMPILATIONS

1. American Jurisprudence Pleading and Practice CD-ROM (OFFSITE LINK)-Excellent!
2. American Jurisprudence Legal Forms 2d CD (OFFSITE LINK)-Excellent!
3. Superforms- tax forms

4. OTHER FORMS SITES

NOTE: All of the links below are offsite links. We have no relationship with any of these parties.

4.1 General Forms

1. Sovereignty Forms and Instructions: Forms- Family Guardian
2. Common Law Venue: Forms Page

4.2 Tax Forms

1. Federal Forms and Publications- Family Guardian. Includes modified versions of most Federal Forms
2. Internal Revenue Service: Forms and Publications- WARNING: The forms from the IRS are designed to prejudice your rights and destroy your privacy. They ask for information that you aren't obligated by law to provide. You are much better off using the altered and "improved" versions of their forms posted on the Family Guardian website in link #2 above.
3. State Tax Forms
4. State Income Taxes
5. 1040.com-tax forms

4.3 Legal Forms

1. ContractStore
2. CourtTV Legal Forms
3. E-Z Legal forms
4. FindForms.com
5. Free Legal Forms -Pre-Paid Legal Services
6. HotDocs -legal forms preparation software
7. Law Forms USA
8. Law Guru -legal forms archive
9. Lectric Law Library: General Forms
10. Legal Forms On Demand
11. Legal Kits
12. LegalZoom
13. LexisOne Free Legal Forms -requires HotDocs installed, in most cases
14. U.S. Court Forms
15. U.S. Legal Forms
16. Versus Law U.S. Legal forms

SOCIAL SECURITY: Idolatry and Slavery

http://www.mercyseat.net/BROCHURES/ssnarticle.htm

SOCIAL SECURITY:

Idolatry and Slavery

By Pastor Matt Trewhella

Mercy Seat Christian Church 10240 W. National Ave. PMB #129 West Allis, Wisconsin 53227

The Bible addresses all matters of life. In this pamphlet is an outline establishing that the Bible stands in opposition to the Social Security system enacted in America in 1935. Social Security is an unBiblical, idolatrous system for the following reasons:

1. Social Security is a violation of the 1st Commandment.

God says in Exodus chapter 20, verse 2, "I am the Lord your God, who brought you out of the land of Egypt, out of the house of bondage." He then says in verse 3, "You shall have no other gods before Me." This is the first commandment. In this commandment, God forbids us to have any other gods. He forbids idolatry. Hence, in the first commandment, God requires that we fear, love, and trust Him above all things. We trust God above all things when we commit our lives completely to His keeping and rely on Him for help in every need (Psalm 118:8,9; Matthew 6:25-34; Philippians 4:19). When it comes to Social Security, the State is demanding that we trust it for our needs in our old age. When the State demands that we trust in it for such needs, it is usurping the place of God because the State has no God-given authority to demand that it care for people in their old age. It is demanding that it be recognized as God. It is declaring itself to be a god. Therefore, Social Security is a violation of the 1st commandment.

2. Social Security is a violation of the 10th Commandment.

God says in Exodus chapter 20, verse 17, "You shall not covet your neighbors' house, you shall not covet your neighbor's wife, nor his man-servant, nor his maid-servant, nor his ox, nor his ass, nor any thing that is your neighbors." In this commandment, God forbids every sinful desire to get our neighbors' possessions openly or by trickery. Hence, He requires us to be content with what He has given us. Dorcas Hardy, who was the Commissioner of Social Security from 1986 to 1989, in her book *Social Insecurity*, makes it clear that Social Security is not insurance, nor is it a pension. She states that Social Security is *"a transfer of wealth from young to old."* Social Security is the State taking money from one group of people and giving it to another group of people. It is old people coveting young people's money through the coercive arm of the State. The covetous nature is seen in old people by how vociferously they respond to any legislation which might touch Social Security (Colossians 3:5). They have an attitude of "I've paid all these years, so I want mine." Therefore, Social Security is a violation of the 10th commandment because it is based on covetousness and it breeds covetousness.

3. Social Security violates God's work ethic.

The Bible has much to say against laziness. Sluggards and sloths are mentioned 15 times in the book of Proverbs alone. Proverbs 26:14 states, "As the door turns upon its hinges, so doth the slothful upon his bed." The Bible extols the virtues of

hard work, yet says nothing about retirement. God requires us to be honest and industrious and to help our neighbor in their need. Retirement is what Americans look forward to in order to pursue their own self-interests such as golf and fishing. Rarely is retirement used as an opportunity for further service to God. At the turn of the century, two-thirds of the men over age 65 were still working. Today, since Social Security was enacted, 5 out of 6 men over the age of 65 are *not* working. Social Security encourages laziness and self-centeredness, therefore, Social Security violates God's work ethic.

4. Social Security violates the jurisdiction of the Family and the Church.

God has established four governments. 1.) Self-government 2.) Family government 3.) Church government, and 4.) Civil government. Each government has its own jurisdiction and function. The Scripture declares in First Timothy chapter 5, verse 8, "But if anyone does not provide for his own, and especially those of his household, he has denied the faith and is worse than an infidel." God has established that *families* provide for the needs of their members. Sadly, many children do not want to care for their parents in their old age. They like the State to care for their parents so that they can carry on with their self-centered life. God has also established that when the need is too much to bear for the family alone, the Church is to help with the needs of the family (Romans 12:13; Galatians 6:10). The Scriptures *do not* place care for the needs of the family in the hands of the State. Social Security is an attempt to bypass God's order and trust the State to care for our needs, or the needs of our parents, in old age, therefore, Social Security violates the jurisdiction of the family and the Church.

5. Social Security undermines the Family.

The family's chief end is to glorify God, obey His laws, advance His kingdom, and enjoy His blessings, now and forever. The enemies of God and the family are all those who seek to destroy the family and tread upon God's Holy Law. When the State demands that we trust in it for our needs, it is usurping the place of God. It is demanding that it be recognized as God. The reason the State wants people to trust in it for their needs is because it wants to win the allegiance of family members to itself (rather than to one another). The State knows that if we trust in it for our needs, it *will* win our allegiance. Therefore, Social Security undermines our allegiance to our family members and to God. It is an attack on the family and a violation of God's Holy Law (Exodus 20:3,12).

6. A person who numbers his child with the State is giving him or her a mark.

In Ezekiel 9:4-6, God instructs one of His agents to "put a mark on the foreheads of the men who sigh and cry over all the abominations that are done" within Jerusalem. All were to be slain except those who received the mark. They were spared death. They belonged to the Lord. In Exodus 12, the doorposts were marked with blood so that the destroyer did not touch those who belonged to the Lord. In Revelation 7:3, we see that God seals those that are His on their foreheads. Satan also wants to mark those that are his. In Revelation 13:16-17, he marks them in the forehead and hand with a number. A mark is a sign of ownership. Webster's Dictionary defines *mark* as "a letter, numeral etc. put on something to indicate quality, provenance, ownership etc." The Social Security number establishes a guardian/ward relation with the State. A number given by the State for such a purpose denotes ownership by the State, therefore we should not allow our children to be numbered by the State. Our children belong to God, not the State.

7. A person who numbers his child with the State renders unto Caesar that which is not Caesar's.

Marriage is the joining together by God of a man and a woman in order to raise a family and exercise dominion. Children, under the parents' God-bestowed authority, are to receive education and discipline, and are to be trained as trustees of the family property. In the family, the husband, under Christ's leadership, is in loving authority over his wife and children, and both parents are in authority over their children as directed by the Bible. The Scriptures teach that children are gifts from God (Psalm 127:3-5). The Scriptures teach that God gives children to parents (I Chronicles 25:5). *Parenthood is a right given by God, not a privilege granted by the State.* Jesus taught, "Render to Caesar the things that are Caesar's, and to God the things that are God's" (Mark 12:17). Children are made in God's image. They bear His inscription, not Caesar's. We are not to render them unto Caesar. A number given by the State denotes ownership by the State, therefore, we should not allow our children to be numbered by the State.

8. A person who numbers his child with the State enslaves his child.

Jesus is Lord, not Caesar. Our children belong to God. They are not to be the slaves of men. What is the purpose of a number given by the State? *Control*. The State wants to control, which is to enslave our children by giving them a number. The Scriptures declare, "You were bought with a price; *do not become the slaves of men*." (I Corinthians 7:23). We are to be the slaves of God (Romans 6:22). We are to be the slaves of Christ (Romans 1:1; Galatians 1:10). He bought us. A number given by the State denotes ownership by the State, therefore, we must uphold the Lordship of Christ and not allow our children to be numbered by the State.

A Historical Perspective

Some years after the Revolutionary War, the U.S. Congress passed a pension plan for all veterans of that war. All veterans desiring a pension were to apply at designated places, show evidence of their military status, and dictate to a court clerk their memories of the war. The resultant memoirs give us vivid glimpses of that war. When you read these memoirs however, you notice a blatant lack of reference to religion or God or the Bible. You are left wondering, "weren't there any Christian people that fought in this war or lived in this era?"

The reason for these blatant omissions to religion, God,or the Bible is because no Christian veteran would apply for a federal pension, and the churches were united in their opposition to any such application. They believed that participation in a state or federal pension plan was morally wrong and idolatrous. They based their stand on many Old Testament and New Testament texts of Scripture. They saw their position summed up by I Timothy 5:8, "But if anyone does not provide for his own, and especially those of his household, he has denied the faith and is worse than an infidel." They saw it as their God-given duty to care for their own family members.

What a contrast to the Church in 1935 when Social Security was implemented. Churches stood by in silence and submitted to this act of aggression by the State into the jurisdiction of the Family and the Church. In fact, by 1954, clergymen were added to the list of those who could be a part of the Social Security system because the clergy in this nation begged to be a part of it.

If you would like a large packet of information in order to learn more about this important topic, send fifteen dollars to:

Mercy Seat Christian Church
10240 W. National Ave. PMB #129
Milwaukee, WI 53227
262-675-2804

This pamphlet is available in print form. Click here to order.

SOME FURTHER THOUGHTS REGARDING SOCIAL SECURITY:

Getting a Social Security number is voluntary. There is no law or statute which requires you to obtain one either for yourself or your child. A brochure which I obtained from the Social Security Administration in March

of 1997, entitled *Numbers for Newborns*, asks the question, "Must My Baby Have A Social Security Number Now?" The answer given in the brochure states, "No! Getting a Social Security number for your baby is strictly **voluntary**."

Now, so often when the State says something is "voluntary", they use some other device to try and coerce you into "volunteering". For example, when it comes to the School to Work program which is being initiated in Wisconsin and throughout the nation, they will say "taking this Certificate of Mastery test is purely voluntary." But then they tell you, "Oh, but if you don't take the test you are automatically excluded from getting the best jobs in society." This is the underhanded deception of the State. They will try to "coax" you into volunteering. The carrot is usually money. When it comes to Social Security, the State says getting a Social Security number is voluntary. But then the IRS comes along and says you cannot claim your child as an exemption on your tax return and get a refund unless you have a Social Security number for him or her.

The past. In the past, those who did not have Social Security numbers for their children and therefore did not put any numbers on their tax returns, simply received a letter of warning from the IRS, stating that they must have Social Security numbers on their return next year or they would be penalized. They would be told that the IRS would let it go this year, but next year they must have the numbers. My wife, Clara, and I received these letters for ten years. We were never penalized.

The present. In 1996 however, things changed. Section 151(e) of the Internal Revenue Code was changed by the GATT/WTO legislation. Three families in our congregation no longer merely received a threatening letter, but were sent notice by the IRS that they could not get their refund without their children having Social Security numbers. They were told they now owed the IRS money because they could not claim their children as dependents without the number. All three families wrote to the IRS stating that they have *religious objections* to getting their children Social Security numbers. Two of the three families have since received their tax refund *without* Social Security numbers for their children. The third family is still waiting to hear from the IRS.

(A side note. The family who is still waiting to hear from the IRS, formerly received Social Security benefits. The mother in this family had been married before. Her first husband died. The daughter from her first marriage was receiving survivor benefits from Social Security as a result. But because of coming to realize that Social Security is unBiblical and idolatrous, they wrote to the Social Security Administration to refuse receiving further money from it. So, here they refused to receive money from the State through Social Security, but now the State is harassing them over Social Security numbers.)

The future. 1997 stands to be an interesting year. In 1996, Congress passed the Small Business Jobs Protection Act which contained legislation which once again modified Section 151(e) of the Internal Revenue Code. The modification further strengthens the language that you must have a Social Security number for your children in order to claim them as dependents. (*Update: See article enclosed titled - *What to do when the IRS sends you notice that they will not send you your refund because you don't have Social Security numbers for your children*.)

Supplemental Security Income. The Supplemental Security Income (SSI) is administered by the Social Security Administration. SSI gives $5000.00 to $20,000.00 "backpay" checks to drug addicts and drunkards (and for a host of other lame reasons) for their "disability." They then pay these people $500.00 a month because of their "disability." This is not compassion. This money does not help these people, it hurts them. Why? Because they take it and booze up for a few days until their broke. This enables them economically to continue in their "disability", it does not help them. Many end up in hospitals after their livers finally fail. You're told that the money taken from your check each week for Social Security does not go toward SSI, but it really does, in part at least. Each year there is a surplus of money given to Social Security. This is not kept in some little account for you somewhere, rather the surplus is put into the "general" tax fund. SSI is part of the "general" tax fund. So, drug addicts and drunkards are rewarded by our government, but honest, hardworking families, like the one

mentioned above from our congregation, are harassed by it.

How Do We Respond To The UnBiblical Social Security System?

When a teaching like this is given, there is potential for people to become judgmental or harsh.

First, we must repent of the idolatry we have been involved in when it comes to Social Security, and we must call others to repentance too. We must recognize that God is the one in whom we are to trust, not the State. We must also recognize that while repentance and forgiveness are instant gifts of God's mercy and grace, it takes time, discipline, hard work, sacrifice, and perseverance to "rebuild the walls that have fallen down."

RESTRUCTURING OUR LIVES - *WHAT INDIVIDUALS CAN DO*.

A.) People who receive Social Security money. The elderly people who are receiving Social Security benefits, or are nigh to receiving benefits, should consider refusing to receive the benefits if they can financially do without them, or if they can continue to work. They should also see if their children or other family members can help them in their financial situation if they need it now, or if they cannot work as much or at all in the near future. Children should understand that it is their God-given duty before God to care for their parents in their old age (Exodus 20:12; I Timothy 5:8). However, those elderly people who are unable to do without their Social Security money because of their situation should not be held in ill repute for the following reasons:

1. They were deceived all of their lives by our government into thinking that Social Security was insurance, or a pension, or that there were little individual accounts that they were paying into and when they turn 65 they'll get it back. They were deceived all of their lives, therefore they were planning on having this money in their old age. They did not structure their lives to do without it. Now, in their old age, it *could* be impossible for them to restructure to do without it with as few years as they have left to live.

2. Many elderly people have children who refuse to do their God-given duty and care for their parents in their old age. These children have believed the Statist lie that their parents should be cared for by the State and not by them.

3. We are dealing with generational sin when it comes to Social Security. When the people of God see a sin which has been going on for generations in their midst, and repent of it, it can be so imbedded in the culture that it takes *time* and much restructuring to root it out (read Nehemiah).

B.) No young Christian should receive Social Security benefits. No Christian should be receiving SSI benefits. We should not get our children Social Security numbers. We should all work to see the Social Security system abolished.

(Important note. When your child is born at a hospital, the hospital personnel will come to you and ask that you fill out the birth certificate form and check the box to receive a Social Security number for your child. Refuse to do so. Just record your child's birth in your Family Bible. If they try to tell you that you cannot leave the hospital unless you fill out the birth certificate form and check the box to receive a Social Security number, just ask them "what are the terms of this kidnapping?" They will back off real fast. Remember, receiving a Social Security number is voluntary. So is receiving a birth certificate. You are not required to sign for or fill out either. You need to know that many hospitals now automatically apply for your child to get a Social Security number when you fill out the birth certificate form. You need neither (regardless of what they tell you) and you're wise not to fill out or sign for either.)

RESTRUCTURING OUR LIVES - *WHAT CHURCHES CAN DO.*

God uses the wicked for His purposes. Sometimes He uses what the wicked do for good in His people's lives. What they mean for evil, God can use for good. Social Security looks like tyranny, and it is. But God could use it to get His people out of their *safety zones*. Upon recognizing Social Security for what it is, namely idolatry, Christians could begin new jobs, new trades, entrepreneurship could explode, a parallel economy could be established, Christian colleges could begin to set up their own accreditation boards rather than going to the pagans for accreditation. Or some of God's people might consider more earnestly going into the ministry or into missions. We need to have compassion, band together, and help each other out in restructuring our lives to be free and not part of the idolatrous Social Security system.

A.) Churches should preach about Social Security. The Bible speaks to all matters of life. The pulpits in America need to condemn this system for what it is - blatant idolatry. Pastors need to preach sermons about *The Bible and Social Security*, and expose it for what it is. In 1976, economist Jodie Allen, who is a socialist, wrote an article in the *Washington Post* entitled *Social Security: The Largest Welfare Program*. She details the response she received and what she learned:

I was deluged with calls and letters from the guardians of the Social Security system saying, "Gee, Jodie, we always liked you but how could you say this." I acted very politely and I said, "Well, what's the matter with this, isn't it true?" And they said, "Oh, yes, it's true, but once you start saying this kind of thing, you don't know where it's going to end up." Then I came to perceive that Social Security was not a program, it was a religion. It's very hard to reform a religion.

And it is a religion. Social Security is socialism. Socialism puts man at the center, and makes the State god. As a religion, the State has every intention of enforcing its law/order. By the State demanding that we trust in it for our needs, it is usurping the place of God. It is demanding that it be recognized as God. This idolatrous system should be condemned by pulpits in America, and people should be called upon to repent of their idolatry for receiving from it or paying homage to it.

B.) Churches should stand with those who are persecuted by the State. Our congregation has every intention of helping the family that's still waiting to hear from the IRS. Churches should make sure they stand with families who are harassed by the IRS. This includes helping them finance a fight in the courts, or staging an effort with Congressmen to get new laws passed to see that the harassment ceases.

C.) Churches should help those families that are in need. There are times when the burden to meet a family member's needs becomes too great for the family alone. In such times, the church should step forward to help. An elderly person upon recognizing the idolatry of Social Security might want to no longer be a part of it, but simply cannot afford not receiving all or some of the money. The church should consider what it might be able to do in such a situation. A system should be established within the church whereby people can approach the deacons when they are in serious need.

(Important note. We are not to be moving people from a statist welfare system to an ecclesiastical welfare system. It is primarily the *family's* responsibility to care for the needs of its members. The church steps in to help only when the need becomes too great.)

D.) Churches should help organize apprenticeships. This is important if we are going to see the next generation raised to know what it means to be a freeman. Churches could hold meetings with their men and women to brainstorm as how to live in this culture without a Social Security number. The meetings could also serve to hook young people up with other men or women in the church who could apprentice them in a trade. We must

restructure and begin to rebuild the wall.

FINAL NOTE - the Church of old versus the present day Church.

Some will say, "Though I participate in the Social Security system, it is not idolatrous because I know in my heart that the State isn't God, nor am I trusting in the government to meet my needs."

We must remember however, idolatry is not just a condition of the heart - *it is an action.* The early Church could have easily said, "You know that I don't believe that the Emperor is God, Lord. I know he's a false god. You also know, Lord, that if I don't throw in this pinch of incense I will be jailed and well, I have a responsibility to provide for my family. You know my heart, Lord." They could have easily justified and rationalized throwing in the pinch of incense. But they didn't because they knew that idolatry wasn't just a condition of the heart - it was an action, and by throwing in the incense they were committing idolatry.

I considered entitling this article *Social Security: None Dare Call it Idolatry*. Why? Because we are all up to our eyeballs in this economic system (especially those who have national ministries or are in comfortable denominational positions and could therefore inform thousands about the idolatrous nature of the Social Security system). Many will therefore chafe at this position paper because they have so much treasure built up in this economic system they never want to see it fall even though the Social Security system is idolatrous and unBiblical. It is because their god is the god of money and not the God of the Bible that they *dare not call it idolatry*.

God help us to repent, and trust in Him as He has decreed!

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THE GREAT IRS HOAX: WHY WE DON'T OWE INCOME TAX

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Welcome to our free download page. The *Great IRS Hoax: Why We Don't Owe Income Tax* is a an ***amazing*** documentary that exposes the lie that the IRS and our tyrannical government "servants" have foisted upon us all these years:

> *"That we are liable for IRC Subtitle A income tax as American Nationals living in the 50 states of the Union with earnings from within the 50 states of the Union that does not originate from the government."*

Through a detailed and very thorough analysis of both enacted law and IRS behavior unrefuted by any of the 100,000 people who have downloaded the book, including present and former (after they learn the truth!) employees of the Treasury and IRS, it reveals why Subtitle A of the Internal Revenue Code is private law/special law that one only becomes subject to by engaging in an excise taxable activity such as a "trade or business", which is a type of federal employment and agency that puts people under federal jurisdiction who would not otherwise be subject. It proves using the government's own laws and publications and court rulings that for everyone in states of the Union who has not availed themselves of this excise taxable privilege of federal employment/agency, Subtitle A of the I.R.C. is not "law" and does not require the average American domiciled in states of the Union to pay a "tax" to the federal government. The book also explains how Social Security is the de facto mechanism by which "taxpayers" are recruited, and that the program is illegally administered in order to illegally expand federal jurisdiction into the states using private law. This book does not challenge or criticize the constitutionality of any part of the Internal Revenue Code nor any state revenue code, but simply proves that these codes are being misrepresented and illegally enforced by the IRS and state revenue agencies against persons who are not their proper subject. This book might just as well be called *The Emperor Who Had No Clothes* because of the massive and blatant fraud that it exposes on the part of our public servants.

"But Dad, the emperor is naked!"

Five years of continuous research by the author(s) and their readers went into writing this very significant and incredible book. This book is *very different* from most other tax books because:

1. The book is written in part by our tens of thousands of readers and growing...***THAT'S YOU***! We invite and frequently receive good new ideas and materials from legal researchers and ordinary people like YOU, and when we get them, we add them to the book after we research and verify them for ourselves to ensure their accuracy. Please keep your excellent ideas coming, because this is a team effort, guys!
2. *We use words right out of the government's own mouth, in most cases, as evidence of most assertions we make*. If the government calls the research and processes found in this book frivolous, they would have to call the Supreme Court, the Statutes at Large, the Treasury Regulations (26 C.F.R.) and the U.S. Code frivolous, because everything derives from these sources.
3. Ever since the first version was published back in Nov. 2000, we have invited, and even *begged*, the government continually and repeatedly, both on our website and in our book and in correspondence with the IRS and the Senate Finance Committee (click here to read our letter to Senator Grassley under "Political Activism"), and in the We The People Truth in Taxation Hearings to provide a signed affidavit on government stationary along with supporting evidence that disproves *anything* in this book . We have even promised to post the government's rebuttal on our web site *unedited* because we are more interested in the truth than in our own agenda. Yet, some ***criminal public servants*** have consistently and steadfastly refused their legal duty under the First Amendment Petition Clause to answer our concerns and questions, thereby hiding from the truth and obstructing justice in violation of 18 U.S.C. Chapter 73. By their failure to answer they have defaulted and admitted to the complete truthfulness of this book pursuant to Federal Rule of Civil Procedure 8(d). If the "court of public opinion" really were a court, and if the public really were *fully educated* about the law as it is the purpose of this book to bring about, the IRS and our federal government would have been convicted long ago of the following crimes by their own treasonous words and actions thoroughly documented in this book (click here for more details):

    - Establishment of the U.S. government as a "religion" in violation of First Amendment (see section 4.3.2 of this book and our article entitled: Our Government has Become Idolatry and a False Religion)
    - Obstruction of justice under 18 U.S.C. Chapter 73
    - Conspiracy against rights under 18 U.S.C. §241
    - Extortion under 18 U.S.C. §872 .
    - Wrongful actions of Revenue Officers under 26 U.S.C. §7214
    - Engaging in monetary transactions derived from unlawful activity under 18 U.S.C. §1957
    - Mailing threatening communications under 18 U.S.C. §876
    - False writings and fraud under 18 U.S.C. §1018
    - Taking of property without due process of law under 26 CFR §601.106(f)(1)
    - Fraud under 18 U.S.C. §1341
    - Continuing financial crimes enterprise (RICO) under 18 U.S.C. §225
    - Conflict of interest of federal judges under 28 U.S.C. §455
    - Treason under Article III, Section 3, Clause 1 of the U.S. Constitution
    - Breach of fiduciary duty in violation of 26 CFR 2635.101, Executive order order 12731, and Public Law 96-303
    - Peonage and obstructing enforcement under Thirteenth Amendment, 18 U.S.C. §1581 and 42 U.S.C. §1994
    - Bank robbery under 18 U.S.C. §2113 (in the case of fraudulent notice of levies)

4. We keep the level of the writing to where a person of average intelligence and no legal background can understand and substantiate the claims we are making for himself.
5. We show you how and where to go to substantiate every claim we make and we encourage you to check the facts for yourself so you will believe what we say is absolutely accurate and truthful.
6. All inferences made are backed up by extensive legal research and justification, and therefore tend to be more convincing and authoritative and understandable than most other tax books. We assume up front that you will

question *absolutely every assertion* that we make because we encourage you to do exactly that, so we try to defend every assertion in advance by answering the most important questions that we think will come up. We try to reach *no* unsubstantiated conclusions whatsoever and we avoid the use of personal opinions or anecdotes or misleading IRS publications. Instead, we always try to back up our conclusions with evidence or an authoritative government source such as a court cite or a regulation or statute or quotes from the authors of the law themselves, and we verify every cite so we don't destroy our credibility with irrelevant or erroneous data or conclusions. Frequent corrections and feedback from our 100,000 readers (and growing) also helps considerably to ensure continual improvements in the accuracy and authority and credibility of the document.

7. Absolutely everything in the book is consistent with itself and we try very hard not to put the reader into a state of "cognitive dissonance", which is a favorite obfuscation technique of our public dis-servants and legal profession. No part of this book conflicts with any other part and there is complete "cognitive unity". Every point made supports and enhances every other point. If the book is truthful, then this must be the case. A true statement cannot conflict with itself or it simply can't be truthful.
8. With every point we make, we try to answer the question of "why" things are the way they are so you can understand our reasoning. We don't flood you with a bunch of rote facts to memorize without explaining why they are important and how they fit in the big picture so you can decide for yourself whether you think it is worth your time to learn them. That way you can learn to think strategically, like most lawyers do.
9. We practice exactly what we preach and what we put in the book is based on lessons learned actually doing what is described. That way you will believe what we say and see by our example that we are very sincere about everything that we are telling you. Since we aren't trying to sell you anything, then there *can't* be any other agenda than to help you learn the truth and achieve personal freedom.
10. This is also the ONLY book that explains and compares all the major theories and tax honesty groups and sifts the wheat from the chaff to extract the "best of breed" approach from each advocate which has the best foundation in law and can most easily be defended in court.
11. The entire book, we believe, completely, truthfully, and convincingly answers the following very important question:

    "How can we interpret and explain the Internal Revenue Code in a way that makes it completely lawful and Constitutional, both from the standpoint of current law and from a historical perspective?"

If you don't have a lot of time to read EVERYTHING, we recommend reading at least the following chapters in the order listed: 1, 3, 4, 5 (these are mandatory).

TESTIMONIALS: Click here to hear what people are saying about this book!

If you are from the government and think that this book might be encouraging some kind of illegal activity, click here to find a rebuttal of such an accusation and detailed research on why we are *not* subject to state or federal jurisdiction for anything related to this website or our ministry.

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	Preface and Table of Contents	129	966	PDF	PDF
1	Introduction	115	1,275	PDF	PDF

2	U.S. Government Background	128	1,432		
3	Legal Authority for Income Taxes in the United States	173	1,833		
4	Know Your Citizenship Status and Rights!	376	4,424		
5	The Evidence: Why We Aren't Liable to File Returns or Pay Income Tax	539	5,467		
6	History of Federal Government Income Tax Fraud, Racketeering, and Extortion in the U.S.A.	179	1,864		
7	Case Studies	45	420		
8	Resources for Tax Freedom Fighters	9	97		
9	Definitions	14	220		

The *Great IRS Hoax* book draws on works from several prominent sources and authors, such as:

1. The U.S. Constitution.
2. The Family Constitution
3. Amendments to the U.S. Constitution.
4. The Declaration of Independence.
5. The United States Code (U.S.C.), Title 26 (Internal Revenue Code), both the current version and amended past versions.
6. U.S. Supreme Court Cases.
7. U.S. Tax Court findings.
8. The Code of Federal Regulations (CFR), Title 26, both the current version and amended past versions.
9. IRS Forms and Publications (directly from the IRS Website at http://www.irs.gov).
10. U.S. Treasury Department Decisions.
11. Federal District Court cases.
12. Federal Appellate (circuit) court cases.
13. Several websites.
14. A book entitled *Losing Your Illusions* by Gordon Phillips of Private Arena (http://privatearena.com/).

15. A book entitled *IRS Humbug*, by Frank Kowalik.
16. A book entitled *Federal Mafia*, by Irwin Schiff (http://paynoincometax.com).
17. A book entitled *Constitutional Income*, by Phil Hart (http://constitutionalincome.com/).
18. Case studies of IRS enforcement tactics (http://www.neo-tech.com/irs-class-action/).
19. Case studies of various tax protester groups.
20. The IRS' own publications about Tax Protesters.
21. A book entitled *Why No One is Required to File Tax Returns* by William Conklin (http://www.anti-irs.com)
22. Writings of Thomas Jefferson, the author of the Declaration of Independence.
23. Department of Justice, Tax Division, Criminal Tax Manual
24. Several other books mentioned on our Recommended Reading page.

Below is a complete outline of the content of this very extensive work:

PREFACE

Testimonials
Preface
Conventions Used Consistently Throughout This Book
Table of Contents
Table of Authorities

Cases
Statutes
Regulations
Other Authorities

Index
Revision History

1. INTRODUCTION

1.1 Help! Where can I get help with my tax problem?
1.2 Summary of the Purpose of this document
1.3 Who Is This Document Intended To Help?
1.4 Why Should I Believe This Book or Your Website?

1.4.1 Mission statement
1.4.2 Motivation and Inspiration
1.4.3 Ministry
1.4.4 Schooling
1.4.5 Criticism
1.4.6 Pricing
1.3.7 Frequently Asked Questions About Us

1.4.7.1 Question 1: Do you file 1040 forms?
1.4.7.2 Question 2: Do you have any court cites favorable to your position?
1.4.7.3 Question 3: Isn't it a contradiction for you to be working for the government on the one hand and criticizing the government on the other hand.
1.4.7.4 Question 4: Isn't it a contradiction to be paid by the very tax dollars from

the government that you tell people not to pay?
1.4.7.5 Question 5: Do you have to quote the Bible so much?
1.4.7.6 Question 6: Aren't you endangering yourself by criticizing government?
1.4.7.7 Question 7: How come I can't select or copy text from the electronic version of this document?
1.4.7.8 Question 8: I'm afraid to act on the contents of this book. What should I do?

1.5 Who Is Really Liable for the Income Tax?
1.6 Amazing Facts About the Income Tax
1.7 So if citizens don't need to pay income tax, how could so many people be fooled for so long?
1.8 Our Own Ignorance, Laziness, Arrogance, Disorganization, and Apathy: Public Enemy #1
1.9 Political "Tax" Prisoners
1.10 What Attitude are Christians Expected to Have About This Document?

1.10.1 Jesus Christ, Son of God, was a tax protester!
1.10.2 The Fifth Apostle Jesus Called and the first "Sinner" Called to Repentance Were Tax Collectors
1.10.3 The FIRST to Be Judged By God Will Be Those Who Took the Mark of the Beast: The Socialist (Social) Security Number
1.10.4 Our obligations as Christians
1.10.5 Civil Disobedience to Corrupt Governments is a Biblical Mandate
1.10.6 Why you can't trust Lawyers and Most Politicians
1.10.7 How can I wake up fellow Christians to the truths in this book?

1.11 Common Objections to the Recommendations In This Document

1.11.1 Why can't you just pay your taxes like everyone else?
1.11.2 What do you mean my question is irrelevant?
1.11.3 How Come my Accountant or Tax Attorney Doesn't Know This?
1.11.4 Why Doesn't the Media Blow the Whistle on This?
1.11.5 Why Won't the IRS and the US Congress Tell Us The Truth?
1.11.6 But how will government function if we don't pay?
1.11.7 What kind of benefits could the government provide without taxes?
1.11.8 I Believe You But I'm Too Afraid to Confront the IRS
1.11.9 The Views Expressed in This Book are Overly Dogmatic or Extreme

1.12 Analysis of financial impact of ending federal income taxes

2. U.S. GOVERNMENT BACKGROUND

2.1 Code of Ethics for Government Service
2.2 The Limited Powers and Sovereignty of the United States Government
2.3 Thomas Jefferson on Property Rights and the Foundations of Government
2.4 The Freedom Test

2.4.1 Are You Free or Do You Just Think You Are?
2.4.2 Key to Answers
2.4.3 Do You Still Think You Are Free?

2.5 14 Signposts to Slavery
2.6 The Mind-Boggling Burden to Society of Slavery to the Income Tax
2.7 America: Home of the Slave and Hazard to the Brave

2.7.1 Karl Marx's Communist Manifesto: Alive and Well In America

2.7.2 Public (Government) Schooling
2.7.3 The Socialist Plan to Make America Communist
2.7.4 IRS Secret Police/KGB in Action!

2.8 Sources of Government Tyranny and Oppression

2.8.1 Deception: The religion of Satan and our government
2.8.2 Presumption
2.8.3 Illegal Acts and Legal Obfuscation
2.8.4 Propaganda, and Political Warfare
2.8.5 Compelled Income Taxes on Labor (slavery!)
2.8.6 The Socialist (Social) Security Number: Mark of the Beast

2.8.6.1 Coercion: The Enumeration At Birth Program
2.8.6.2 Coercion: Denying Benefits for Those who Refuse to Provide Socialist Security Numbers

2.8.7 National ID Cards
2.8.8 Paper Money

2.8.8.1 What is Money?
2.8.8.2 The Founders Rejected Paper Currency
2.8.8.3 War of Independence Fought Over Paper Money
2.8.8.4 President Thomas Jefferson: Foe of Paper Money
2.8.8.5 Wealth confiscation through inflation
2.8.8.6 The Most Dangerous Man in the Mid South
2.8.8.7 What Type of "Money" Do You Pay Your Taxes With To the IRS?

2.8.9 The Federal Reserve

2.8.9.1 The Federal Reserve System Explained
2.8.9.2 Lewis v. United States Ruling
2.8.9.3 Federal Reserve Never Audited

2.8.10 Debt
2.8.11 Surrendering Freedoms in the Name of Government-Induced Crises
2.8.12 Judicial Tyranny

2.8.12.1 Conflict of Interest and Bias of Federal Judges
2.8.12.2 Sovereign Immunity
2.8.12.3 Cases Tried Without Jury
2.8.12.4 Attorney Licensing
2.8.12.5 Protective Orders
2.8.12.6 "Frivolous" Penalties
2.8.12.7 Non-publication of Court Rulings

2.8.12.7.1 Background
2.8.12.7.2 Publication Procedures Have Been Changed Unilaterally
2.8.12.7.3 Publication is Essential to a Legal System Based on Precedent
2.8.12.7.4 Citizens in a Democracy are Entitled to Consistent Treatment From the Courts
2.8.12.7.5 Operational Realities of Non-publication
2.8.12.7.6 Impact of Non-publication Inside the Courts
2.8.12.7.7 Openness

2.8.12.7.8 Constitutional Considerations
2.8.12.7.9 Opinions Are Necessary, Even in "Insignificant Matters"
2.8.12.7.10 Impact on the Legal System in Society
2.8.12.7.11 Questions to Ponder

2.9 The Social Security Fraud

2.9.1 Social Security is NOT a Contract!
2.9.2 Social Security is Voluntary Not Mandatory
2.9.3 A Legal Con Game (Forbes Magazine, March 27, 1995)
2.9.4 The Legal Ponzi Scheme (Forbes Magazine, October 9, 1995)
2.9.5 The Social Security Mess: A Way Out, (Reader's Digest, December 1995)

2.10 They Told The Truth!: Amazing Quotes About the U.S. Government

2.10.1 ...About The Internal Revenue Service
2.10.2 ...About Social Security
2.10.3 ...About The Law
2.10.4 ...About Money, Banking & The Federal Reserve
2.10.5 ...About the New World Order
2.10.6 ...About the "Watchdog Media"
2.10.7 ...About Republic v. Democracy
2.10.8 ...About Citizens, Politicians and Government
2.10.9 ...About Liberty, Slavery, Truth, Rights & Courage

2.11 Bill of No Rights|
2.12 Am I A Bad American?-Absolutely Not!
2.13 How to Teach Your Child About Politics
2.14 If Noah Were Alive Today
2.15 Prayer at the Opening of the Kansas Senate
2.16 The Ghost of Valley Forge
2.17 Last Will and Testament of Jesse Cornish
2.18 America?
2.19 Grateful Slave
2.20 Economics 101

3. LEGAL AUTHORITY FOR INCOME TAXES IN THE UNITED STATES

3.1 Quotes from Thomas Jefferson on the Foundations of Law and Government
3.2 Biblical Law: The Foundation of ALL Law
3.3 The Purpose of Law
3.4 Natural Law
3.5 The Law of Tyrants
3.6 Basics of Federal Laws

3.6.1 Precedence of Law
3.6.2 Legal Language: Rules of Statutory Construction
3.6.3 How Laws Are Made
3.6.4 Positive Law
3.6.5 Discerning Legislative Intent and Resolving conflicts between the U.S. Code and the Statutes At Large (SAL)

3.7 Declaration of Independence

3.7.1 Dysfunctional Government
3.7.2 God Given Rights
3.7.3 Taxation Without Consent

3.8 U.S. Constitution

3.8.1 Constitutional Government
3.8.2 Enumerated Powers, Four Taxes & Two Rules
3.8.3 Constitutional Taxation Protection
3.8.4 Colonial Taxation Light
3.8.5 Taxation Recapitulation
3.8.6 Direct vs. Indirect Taxes
3.8.7 Article I, Section 8, Clauses 1 and 3: The Power to Tax and Regulate Commerce
3.8.8 Bill of Rights

3.8.8.1 1st Amendment: The Right to Petitioner the Government for Redress of Grievances
3.8.8.2 4th Amendment: Prohibition Against Unreasonable Search and Seizure Without Probable Cause
3.8.8.3 5th Amendment: Compelling Citizens to Witness Against Themselves

3.8.8.3.1 Introduction
3.8.8.3.2 More IRS Double-Speak/Illogic
3.8.8.3.3 The Privacy Act Notice
3.8.8.3.4 IRS Deception in the Privacy Act Notice
3.8.8.3.5 IRS Fear Tactics to Keep You "Volunteering"
3.8.8.3.6 Jesus' Approach to the 5th Amendment Issue
3.8.8.3.7 Conclusion

3.8.8.4 6th Amendment: Rights of Accused in Criminal Prosecutions
3.8.8.5 10th Amendment: Reservation of State's Rights

3.8.9 13th Amendment: Abolition of Slavery
3.8.10 14th Amendment: Requirement for Due Process to Deprive Of Property
3.8.11 16th Amendment: Income Taxes

3.8.11.1 Legislative Intent of the 16th Amendment According to President William H. Taft
3.8.11.2 Understanding the 16th Amendment
3.8.11.3 History of the 16th Amendment
3.8.11.4 Fraud Shown in Passage of 16th Amendment
3.8.11.5 What Tax Is Parent To The Income Tax?
3.8.11.6 Income Tax DNA - Government Lying, But Not Perjury?
3.8.11.7 More Government Lying, Still Not Perjury?
3.8.11.8 There Can Be No Unapportioned Direct Tax
3.8.11.9 The Four Constitutional Taxes
3.8.11.10 Oh, What Tangled Webs We Weave...
3.8.11.11 Enabling Clauses

3.9 U.S. Code (U.S.C.) Title 26: Internal Revenue Code (IRC)

3.9.1 Word Games: Deception Using Definitions

3.9.1.1 "citizen" (undefined)
3.9.1.2 "Compliance" (undefined)

3.9.1.3 "Domestic corporation" (in 26 U.S.C. §7701(a)(4))
3.9.1.4 " Employee" (in 26 U.S.C. §7701)
3.9.1.5 "Foreign corporation" (in 26 U.S.C. §7701(a)(5))
3.9.1.6 " Employer" (in 26 U.S.C. §3401)
3.9.1.7 "Gross Income"(26 U.S.C. Sec. 71-86)
3.9.1.8 "Includes" and "Including" (26 U.S.C. §7701(c))
3.9.1.9 "Income"
3.9.1.10 "Individual" (never defined)
3.9.1.11 “Levy” (in 26 U.S.C. §7701(a)(21))
3.9.1.12 "Liable" (undefined)
3.9.1.13 "Must" means "May"
3.9.1.14 "Nonresident alien" (26 U.S.C. . §7701(b)(1)(B))
3.9.1.15 "Person" (26 U.S.C. . §7701(a)1)
3.9.1.16 "Personal services" (not defined)
3.9.1.17 "Required"
3.9.1.18 "Shall" actually means "May"
3.9.1.19 "State" (in 26 U.S.C. §7701)
3.9.1.20 "Tax" (not defined)
3.9.1.21 "Taxpayer" (in 26 U.S.C. §7701)
3.9.1.22 "Taxpayer" (in 26 U.S.C. §7701)
3.9.1.23 "United States" (in 26 U.S.C. §7701)
3.9.1.24 "U.S. Citizen"
3.9.1.25 "Voluntary" (undefined)
3.9.1.26 "Wages" (in 26 U.S.C. . §3401(a))
3.9.1.27 "Withholding agent" (in 26 U.S.C. §7701)

3.9.2 26 USC Sec. 1: Tax Imposed
3.9.3 26 USC Sec. 61: Gross Income
3.9.4 26 USC Sec. 63: Taxable Income Defined
3.9.5 26 USC Sec. 861: Source Rules and Other Rules Relating to FOREIGN INCOME
3.9.6 26 USC Sec. 871: Tax on nonresident alien individuals
3.9.7 26 USC Sec. 872: Gross income
3.9.8 26 USC Sec. 3405: Employer Withholding
3.9.9 26 USC Sec. 6702: Frivolous Income Tax Return
3.9.10 26 USC Sec. 7201: Attempt to Evade or Defeat Tax
3.9.11 26 USC Sec. 7203: Willful Failure to File Return, Supply Information, or Pay Tax
3.9.12 26 USC Sec. 7206: Fraud and False Statements

3.10 U.S. Code Title 18: Crimes and Criminal Procedure

3.10.1 18 U.S.C. 6002-6003

3.11 U.S. Code Title 5, Sections 551 through 559: Administrative Procedures Act
3.12 Code of Federal Regulations (CFR) Title 26

3.12.1 How to Read the Income Tax Regulations
3.12.2 Types of Federal Tax Regulations

3.12.2.1 Treasury Regulations
3.12.2.2 "Legislative" and "interpretive" Regulations
3.12.2.3 Procedural Regulations

3.12.3 You Cannot Be Prosecuted for Violating an Act Unless You Violate It’s Implementing Regulations
3.12.4 Part 1, Subchapter N of the 26 Code of Federal Regulations
3.12.5 26 CFR Sec. 1.861-8(a): Taxable Income

3.12.6 26 CFR Sec. 1.861-8T(d)(2)(ii)(A): Exempt income
3.12.7 26 CFR Sec. 1.861-8T(d)(2)(iii): Income Not Exempt from Taxation
3.12.8 26 CFR Sec. 1.861-8(f)1: Determination of Taxable Income
3.12.9 26 CFR Sec. 1.863-1: Determination of Taxable Income
3.12.10 26 CFR Sec. 31: Employment Taxes and Collection of Income Taxes at the Source
3.12.11 26 CFR Sec. 31.3401(c)-1: Employee

3.13 Treasury Decisions and Orders

3.13.1 Treasury Delegation of Authority Order 150-37: Always Question Authority!
3.13.2 Treasury Decision Number 2313: March 21, 1916

3.14 Supreme Court Cases Related To Income Taxes in the United States

3.14.1 1818: U.S. v. Bevans (16 U.S. 336)
3.14.2 1883: Butchers' Union Co. v. Crescent City Co. (111 U.S. 746)
3.14.3 1894: Caha v. United States (152 U.S. 211)
3.14.4 1895: Pollack v. Farmer's Loan and Trust Company (157 U.S. 429, 158 U.S. 601)
3.14.5 1900: Knowlton v. Moore (178 U.S. 41)
3.14.6 1901: Downes v. Bidwell (182 U.S. 244)
3.14.7 1906: Hale v. Henkel (201 U.S> 43)
3.14.8 1911: Flint v. Stone Tracy Co. (*220 U.S. 107)*
3.14.9 1914: Weeks v. U.S. (*232 U.S. 383)*
3.14.10 1916: Brushaber vs. Union Pacific Railroad (*240 U.S. 1)*
3.14.11 1916: Stanton v. Baltic Mining (240 U.S. 103)
3.14.12 1918: Peck v. Lowe (247 U.S. 165)
3.14.13 1920: Evens v. Gore (253 U.S. 245)
3.14.14 1920: Eisner v. Macomber (252 U.S. 189)
3.14.15 1922: Bailey v. Drexel Furniture Co. (259 U.S. 20)
3.14.16 1924: Cook v. Tait (265 U.S. 47)
3.14.17 1930: Lucas v. Earl (281 U.S. 111)
3.14.18 1935: Railroad Retirement Board v. Alton Railroad Company (295 U.S. 330)
3.14.19 1938: Hassett v. Welch (303 U.S. 303)
3.14.20 1945: Hooven & Allison Co. v. Evatt (324 U.S. 652)
3.14.21 1959: Flora v. U.S. (362 U.S. 145)
3.14.22 1960: U.S. v. Mersky (361 U.S. 431)
3.14.23 1961: James v. United States (366 US 213, p. 213, 6L Ed 2d 246)
3.14.24 1970: Brady v. U.S. (379 U.S. 742)
3.14.25 1974: California Bankers Association v. Shultz (416 U.S. 25)
3.14.26 1975: Garner v. U.S. (424 U.S. 648)
3.14.27 1976: Fisher v. United States (425 U.S. 391)
3.14.28 1978: Central Illinois Public Service Co. v. United States (435 U.S. 21)
3.14.29 1985: U.S. v. Doe (465 U.S. 605)
3.14.30 1991: Cheek v. United States (498 U.S. 192)
3.14.31 1992: United States v. Burke (504 U.S. 229, 119 L Ed 2d 34, 112 S Ct. 1867)
3.14.32 1995: U.S. v. Lopez (000 U.S. U10287)

3.15 Federal District and Circuit Court Cases

3.15.1 Commercial League Assoc. v. The People, 90 Ill. 166
3.15.2 Jack Cole Co. vs. Alfred McFarland, Sup. Ct. Tenn 337 S.W. 2d 453
3.15.3 1916: Edwards v. Keith 231 F 110, 113
3.15.4 1925: Sims v. Ahrens, 271 SW 720
3.15.5 1937: Stapler v. U.S., 21 F. Supp. AT 739
3.15.6 1937: White Packing Co. v. Robertson, 89 F.2d 775, 779 the 4th Circuit Court
3.15.7 1939: Graves v. People of State of New York (306 S.Ct. 466)

3.15.8 1943: Helvering v. Edison Brothers' Stores, 8 Cir. 133 F2d 575
3.15.9 1946: Lauderdale Cemetary Assoc. v. Mathews, 345 PA 239, 47 A. 2d 277, 280
3.15.10 1947: McCutchin v. Commissioner of IRS, 159 F2d 472 5th Cir. 02/07/1947
3.15.11 1952: Anderson Oldsmobile , Inc. vs Hofferbert, 102 F. Supp. 902
3.15.12 1955: Oliver v. Halstead, 196 VA 992, 86 S.E. 2d 858
3.15.13 1958: Lyddon Co. vs. U.S., 158 Fed. Supp 951
3.15.14 1960: Commissioner of IRS v. Duberstein, 80 5. Ct. 1190
3.15.15 1962: Simmons v. United States, 303 F.2d 160
3.15.16 1969: Conner v. U.S. 303 F. Supp. 1187 Federal District Court, Houston
3.15.17 1986: U.S. v. Stahl, 792 F.2d 1438

3.16 IRS Publications
3.17 Topical Legal Discussions

3.17.1 Uncertainty of the Federal Tax Laws
3.17.2 Reasonable Cause
3.17.3 The Collective Entity Rule
3.17.4 Due Process

3.17.4.1 What is Due Process of Law?
3.17.4.2 Due process principles and tax collection
3.17.4.3 Substantive Rights and Essentials of Due Process

3.17.5 There's No Duty To Convert Money Into Income
3.17.6 What's Income and Why Does It Matter?
3.17.7 The President's Role In Income Taxation
3.17.8 A Historical Perspective on Income Taxes

4. KNOW YOUR CITIZENSHIP STATUS AND RIGHTS!

4.1 Natural Order
4.2 Rights v. Privileges

4.2.1 Rights Defined and Explained
4.2.2 What is the Difference Between a “Right” and a “Privilege”?
4.2.3 Fundamental Rights: Granted by God and Cannot be Regulated by the Government
4.2.4 The Two Classes of Rights: Civil and Political
4.2.5 Why we MUST know and assert our rights and can't depend on anyone to help us
4.2.6 Why you shouldn't cite federal statutes as authority for protecting your rights

4.3 Government

4.3.1 What is government?
4.3.2 Biblical view of taxation and government
4.3.3 The purpose of government: Protection of the weak from harm and evil
4.3.4 Equal protection
4.3.5 How government and God compete to provide "protection"
4.3.6 Separation of powers doctrine
4.3.7 "Sovereign"="Foreign"="Alien"
4.3.8 The purpose of income taxes: government protection of the assets of the wealthy
4.3.9 Why all man-made law is religious in nature
4.3.10 The Unlimited Liability Universe
4.3.11 The result of following government's laws instead of God's laws is slavery, servitude, and captivity
4.3.12 Government-instituted slavery using "privileges"

4.3.13 Our Government has become idolatry and a false religion
4.3.14 Socialism is Incompatible with Christianity
4.3.15 All Governments are Corporations
4.3.16 How public servants eliminate or hide the requirement for "consent" to become "Masters"

4.3.16.1 Rigging government forms to prejudice our rights
4.3.16.2 Misrepresenting the law in government publications
4.3.16.3 Automation
4.3.16.4 Concealing the real identities of government wrongdoers
4.3.16.5 Making it difficult, inconvenient, or costly to obtain information about illegal government activities
4.3.16.6 Ignoring correspondence and/or forcing all complaints through an unresponsive legal support staff that exasperates and terrorizes "customers"
4.3.16.7 Deliberately dumbing down and propagandizing government support personnel who have to implement the law
4.3.16.8 Creating or blaming a scapegoat beyond their control
4.3.16.9 Terrorizing and threatening, rather than helping, the ignorant

4.3.17 Why good government demands more than just "obeying the law"

4.4 The Constitution is Supposed to Make You the SOVEREIGN and the Government Your Servant

4.4.1 The Constitution does not bind citizens
4.4.2 The Constitution as a Legal Contract
4.4.3 How the Constitution is Administered by the Government
4.4.4 If the Constitution is a Contract, why don't we have to sign it and how can our predecessors bind us to it without our signature?
4.4.5 Authority delegated by the Constitution to Public Servants
4.4.6 Voting by Congressman
4.4.7 Our Government is a band of robbers and thieves, and murderers!
4.4.8 Oaths of Public Office
4.4.9 Tax Collectors
4.4.10 Oaths of naturalization given to aliens
4.4.11 Oaths given to secessionists and corporations
4.4.12 Oaths of soldiers and servicemen
4.4.13 Treaties
4.4.14 Government Debts
4.4.15 Our rulers are a secret society!
4.4.16 The agenda of our public servants is murder, robbery, slavery, despotism, and oppression

4.5 The U.S.A. is a Republic, Not a Democracy

4.5.1 Republican mystery
4.5.2 Military Intelligence
4.5.3 Sovereign power
4.5.4 Government's purpose
4.5.5 Who holds the sovereign power?
4.5.6 Individually-held God-given unalienable Rights
4.5.7 A republic's covenant
4.5.8 Divine endowment
4.5.9 Democracies must by nature be deceptive to maintain their power
4.5.10 Democratic disabilities
4.5.11 Collective self-destruction
4.5.12 The "First" Bill of Rights
4.5.13 The mandate remains
4.5.14 What shall we do?

4.5.15 Sorry, Mr. Franklin, "We're All Democrats Now"

4.5.15.1 Introduction
4.5.15.2 Transition to Democracy
4.5.15.3 Current Understanding
4.5.15.4 Democracy Subverts Liberty and Undermines Prosperity
4.5.15.5 Foreign Affairs and Democracy
4.5.15.6 Foreign Policy, Welfare, and 9/11
4.5.15.7 Paying for Democracy
4.5.15.8 Confusion Regarding Democracy
4.5.15.9 The Way Out

4.5.16 Summary

4.6 The Three Definitions of "United States"
4.7 Two Political Jurisdictions: "National government" vs "General/federal government"
4.8 The Federal Zone
4.9 Police Powers
4.10 "Resident", "Residence" and "Domicile"
4.11 Citizenship

4.11.1 Introduction
4.11.2 Sovereignty
4.11.3 "Citizens" v. "Nationals"
4.11.4 Two Classes and Four Types of American Citizens
4.11.5 Federal citizens

4.11.5.1 Types of citizenship under federal law
4.11.5.2 History of federal citizenship
4.11.5.3 Constitutional Basis of federal citizenship
4.11.5.4 The voluntary nature of citizenship: Requirement for "consent" and "intent"
4.11.5.5 How you unknowingly volunteered to become a "citizen of the United States" under federal statutes
4.11.5.6 Presumptions about "citizen of the United States" status
4.11.5.7 Privileges and Immunities of U.S. citizens
4.11.5.8 Definitions of federal citizenship terms
4.11.5.9 Further study

4.11.6 State Citizens/Nationals
4.11.7 Citizenship and all political rights are exercised are INVOLUNTARILY exercised and therefore CANNOT be taxable and cannot be called "privileges"

4.11.7.1 Voting
4.11.7.2 Paying taxes
4.11.7.3 Jury Service
4.11.7.4 Citizenship

4.11.8 "Nationals" and "U.S. Nationals

4.11.8.1 Legal Foundations of "national" Status
4.11.8.2 Voting as a "national" or "state national"
4.11.8.3 Serving on Jury Duty as a "national" or "state national"
4.11.8.4 Summary of Constraints Applying to "national" status
4.11.8.5 Rebutted arguments against those who believe people born in the states of the Union are not "nationals"

4.11.8.6 Sovereign Immunity of American Nationals

4.11.9 Rights Lost by Becoming a Federal Citizen
4.11.10 How do we lose our sovereignty and become U.S. citizens?
4.11.11 Expatriation

4.11.11.1 Definition
4.11.11.2 Right of expatriation
4.11.11.3 Compelled expatriation as a punishment for a crime
4.11.11.4 Amending your citizenship status to regain your rights: Don't expatriate!

4.11.12 How the Government Has Obfuscated the Citizenship Issue to Unwittingly Make Us All "U. S. citizens"
4.11.13 Duties and Responsibilities of Citizens
4.11.14 Citizenship Summary

4.12 Two of You
4.13 Contracts
4.14 Our rights

4.14.1 No forced participation in Labor Unions or Occupational Licenses
4.14.2 Property Rights
4.14.3 No IRS Taxes
4.14.4 No Gun Control
4.14.5 Motor Vehicle Driving
4.14.6 Church Rights
4.14.7 No Marriage Licenses

4.14.7.1 REASON #1: The Definition of Marriage License Demands that we not Obtain One To Marry
4.14.7.2 REASON #2: When You Marry With a Marriage License, You Grant the State Jurisdiction Over Your Marriage
4.14.7.3 REASON #3: When You Marry With a Marriage License, You Place Yourself Under a Body of Law Which is Immoral
4.14.7.4 REASON #4: The Marriage License Invades and Removes God-Given Parental Authority
4.14.7.5 REASON #5: When You Marry with a Marriage License, You Are Like a Polygamist
4.14.7.6 When does the State Have Jurisdiction Over a Marriage?
4.14.7.7 History of Marriage Licenses in America
4.14.7.8 What Should We Do?

4.15 Sources of government authority to interfere with your rights
4.16 A Citizens Guide to Jury Duty

4.16.1 Jury Power in the System of Checks and Balances:
4.16.2 A Jury's Rights, Powers, and Duties:
4.16.3 Jurors Must Know Their Rights:
4.16.4 Our Defense - Jury Power:

4.17 The Buck Act of 1940

4.17.1 The united States of America
4.17.2 The "SHADOW" States of the Buck Act

4.18 Conflicts of Law: Violations of God's Laws by Man's Laws
4.19 How Do We Assert Our First Amendment Rights and How Does the Government Undermine Them?
4.20 The Solution

5. THE EVIDENCE: WHY WE AREN'T LIABLE TO FILE RETURNS OR PAY INCOME TAX

5.1 Introduction to Federal Taxation

5.1.1 The Power to Create is the Power to Tax
5.1.2 You Don't Pay "Taxes" to the IRS: You are instead subsidizing socialism
5.1.3 Lawful Subjects of Constitutional Taxation within States of the Union
5.1.4 Direct Taxes Defined
5.1.5 The Internal Revenue Code subtitle A is an indirect excise tax
5.1.6 What type of Tax Are You Paying the IRS--Direct or Indirect?
5.1.7 The Income Tax: Constitutional or Unconstitutional?
5.1.8 Taxable persons and objects within the I.R.C. Subtitle A
5.1.9 The "Dual" nature of the Internal Revenue Code
5.1.10 Brief History of Court Rulings Which Establish Income Taxes on Citizens outside the "federal zone" as "Direct Taxes"
5.1.11 The "Elevator Speech" version of the federal income tax fraud

5.2 Federal Jurisdiction to Tax

5.2.1 Territorial Jurisdiction
5.2.2 Sovereignty: Key to Understanding Federal Jurisdiction
5.2.3 Dual Sovereignty
5.2.4 The TWO sources of federal jurisdiction: "Domicile" and "Contract"
5.2.5 "Public" v. "Private" employment: You really work for Uncle Sam and not Your Private Employer If You Receive Federal Benefits
5.2.6 Social Security: The legal vehicle for extending Federal Jurisdiction into the states using Private/contract law
5.2.7 Oaths of Allegiance: Source of ALL government jurisdiction over people
5.2.8 How Does the Federal Government Acquire Jurisdiction Over an Area?
5.2.9 Limitations on Federal Taxation Jurisdiction
5.2.10 "United States" in the Internal Revenue Code means "federal zone"
5.2.11 "State" in the Internal Revenue Code mans a "federal State" and not a Union State
5.2.12 "foreign" means outside the federal zone and “foreign income” means outside the country in the context of the Internal Revenue Code
5.2.13 Background on State v. Federal Jurisdiction
5.2.14 Constitutional Federal Taxes under the I.R.C. apply to Imports (duties), Foreign Income of Aliens and Corporations, and Domiciliaries Living Abroad
5.2.15 "Employee" in the Internal Revenue Code mans appointed or elected government officers
5.2.16 The 50 States are "Foreign Countries" and "foreign states" with Respect to the Federal Government
5.2.17 You're not a "citizen" under the Internal Revenue Code
5.2.19 Rebutted DOJ and Judicial Lies Regarding Federal Jurisdiction

5.3 Know Your Proper Filing Status by Citizenship and Residency!

5.3.1 "Taxpayer" v. "Nontaxpayer"
5.3.2 A "return" is NOT a piece of paper within the I.R.C., it's a kickback of a federal payment
5.3.3 Summary of Federal Income Tax Filing Status by Citizenship and Residency.
5.3.4 What's Your Proper Federal Income Tax Filing Status?
5.3.5 Summary of State and Federal Income Tax Liability by Domicile and Citizenship

5.3.6 How to Revoke Your Election to be Treated as a U.S. Resident and Become a Nonresident
5.3.7 What Are the Advantages and Consequences of Filing as a Nonresident Citizen?
5.3.8 Tactics Useful for Employees of the U.S. Government

5.4 The Truth About "Voluntary" Aspect of Income Taxes

5.4.1 The true meaning of "voluntary"
5.4.2 "Law" or "Contract"?

5.4.2.1 Public v. Private law
5.4.2.2 Why and how the government deceives you into believing that "private law" is "public law" in order to PLUNDER and ENSLAVE you unlawfully
5.4.2.3 Comity
5.4.2.4 Positive Law
5.4.2.5 Justice
5.4.2.6 Invisible consent: The Tool of Tyrants

5.4.3 Understanding Administrative Law
5.4.4 The three methods for exercising our Constitutional right to contract
5.4.5 Federalism
5.4.6 The Internal Revenue Code is not Public or Positive Law, but Private Law

5.4.6.2 Proof that the I.R.C. is not Positive Law
5.4.6.3 The "Tax Code" is a state-sponsored Religion, not a law
5.4.6.4 How you were duped into signing up to the contract and joining the state-sponsored religion and what the contract says
5.4.6.5 Modern tax trials are religious "inquisitions" and not valid legal processes
5.4.6.6 How to skip out of "government church worship services"

5.4.7 No Taxation Without Consent
5.4.8 Why "domicile" and income taxes are voluntary

5.4.8.1 Definition
5.4.8.2 "Domicile"="allegiance" and "protection"
5.4.8.3 Domicile is a First Amendment choice of political affiliation
5.4.8.4 "Domicile" and "residence" compared
5.4.8.5 Choice of Domicile is a voluntary choice
5.4.8.6 Divorcing the "state": Persons with no domicile
5.4.8.7 You can only have one Domicile and that place and government becomes your main source of protection
5.4.8.8 Affect of domicile on citizenship and synonyms for domicile
5.4.8.9 It is idolatry for Christians to have an earthly domicile
5.4.8.10 Legal presumptions about domicile
5.4.8.11 How the government interferes with your ability to voluntarily choose a domicile
5.4.8.12 Domicile on government forms
5.4.8.13 The Driver's License Trap: How the state manufactures privileged "residents"

5.4.9 The IRS is NOT authorized to perform enforcement actions
5.4.10 I.R.C. Subtitle A is voluntary for those with no domicile in the District of Columbia and no federal employment
5.4.11 The money you send to the IRS is a Gift to the U.S. government
5.4.12 Taxes paid on One's Own Labor are Slavery
5.4.13 The word "shall" in the tax code actually means "may"
5.4.14 Constitutional Due Process Rights in the Context of Income Taxes

5.4.14.1 What is Due Process of Law?
5.4.14.2 Violation of Due Process using "Presumptions"
5.4.14.3 Substantive Rights and Essentials of Due Process Background
5.4.14.4 Due Process principles and tax collection

5.4.15 IRS has NO Legal Authority to Assess You With an Income Tax Liability
5.4.16 IRS Has No Legal Authority to Assess Penalties on Subtitle A Income Taxes
5.4.17 No Implementing Regulations Authorizing Collection of Subtitles A through C income Taxes on Natural Persons
5.4.18 No Implementing Regulations for "Tax Evasion" or "Willful Failure to File" Under 26 U.S. C. §§7201 or 7203!
5.4.19 The "person" addressed by criminal provisions of the IRC isn't you!
5.4.20 The Secretary of the Treasury Has NO delegated Authority to Collect Income Taxes in the 50 States!
5.4.21 The Department of Justice has NO Authority to Prosecute IRC Subtitle A Income Tax Crimes!
5.4.22 The federal courts can't sentence you to federal prison for Tax crimes if you are a "U.S. citizen" and the crime was committed outside the federal zone
5.4.23 You Don't Have to Provide a Social Security Number on Your Tax Return
5.4.24 Your private employer Isn't authorized by law to act as a federal "withholding agent"
5.4.25 The money you pay to government is an illegal bribe to public officials
5.4.26 How a person can "volunteer" to become liable for paying income tax?
5.4.27 Popular illegal government techniques for coercing "consent"

5.4.27.1 Deceptive language and words of art
5.4.27.2 Fraudulent forms and publications
5.4.27.3 Political propaganda
5.4.27.4 Deception of private companies and financial institutions
5.4.27.5 Legal terrorism
5.4.27.6 Coercion of federal judges
5.4.27.7 Manipulation, licensing, and coercion of CPA's, Payroll clerks, Tax Preparers, and Lawyers

5.5 Why We Aren't Liable to *File* Tax Returns or Keep Records

5.5.1 It's illegal and impossible to "file" your own tax return
5.5.2 Why God says you can't file tax returns
5.5.3 You're Not a "U.S. citizen" If You File Form 1040, You're an "Alien"!
5.5.4 You're NOT the "individual" mentioned at the top of the 1040 form if you are a "U.S. citizen" Residing in the "United States"**!
5.5.5 No Law Requires You to Keep Records
5.5.6 Federal courts have NO statutory authority to enforce criminal provisions of the Internal Revenue Code outside the federal zone
5.5.7 Objections to filing based on Rights
5.5.8 Do We Have to Sign the 1040 Form Under Penalty of Perjury?

5.5.8.1 Definitions
5.5.8.2 Exegesis
5.5.8.3 Conclusion
5.5.8.4 Social Comment

5.5.9 1040 and Especially 1040NR Tax Forms Violate the Privacy Act and Therefore Need Not Be Submitted

5.5.9.1 IRS Form 1040

5.5.9.2 IRS Form 1040NR
5.5.9.3 Analysis and Conclusions

5.5.10 If You Don't File, the IRS Can't File a Substitute for Return for You Under 26 U.S.C. §6020 (b)

5.6 Why We Aren't Liable to *Pay* Income Tax

5.6.1 There's No Statute Making Anyone Liable to Pay Subtitle A Income Taxes!
5.6.2 Your income isn't taxable because it is "notes" and "obligations" of the U.S. government
5.6.3 Constitutional Constraints on Federal Taxing Power
5.6.4 Exempt Income
5.6.5 The Definition of "income" for the purposes of the Internal Revenue Code
5.6.6 Gross Income
5.6.7 You Don't Earn "Wages" So Your Earnings Can't be Taxed
5.6.8 Employment Withholding Taxes are Gifts to the U.S. Government!
5.6.9 The Deficiency Notices the IRS Sends to Individuals are Actually Intended for Businesses!
5.6.10 The Irwin Schiff Position
5.6.11 The Federal Employee Kickback Position
5.6.12 You don't have any taxable sources of income
5.6.13 The "trade or business" scam

5.6.13.1 Introduction
5.6.13.2 Proof IRC Subtitle A is an Excise tax only on activities in connection with a "trade or business"
5.6.13.3 Synonyms for "trade or business"
5.6.13.4 I.R.C. requirements for the exercise of a "trade or business"
5.6.13.5 Willful IRS deception in connection with a "trade or business"
5.6.13.6 Proving the government deception yourself
5.6.13.7 How the "scheme" is perpetuated
5.6.13.8 False IRS presumptions that must be rebutted
5.6.13.9 Why I.R.C. Subtitle A income taxes are "indirect" and Constitutional
5.6.13.10 The scam is the basis for all income reporting used to enforce income tax collection
5.6.13.11 How the scam affects you and some things to do about it
5.6.13.12 Other important implications of the scam
5.6.13.13 Further study

5.6.14 The Nonresident Alien Position

5.6.14.1 Why all people born in states of the Union are "nonresident aliens" under the tax code
5.6.14.2 Tax Liability and Responsibilities of Nonresident Aliens
5.6.14.3 How "Nonresident Alien Nontaxpayers" are tricked into becoming "Resident Alien Taxpayers"
5.6.14.4 Withholding on Nonresident Aliens
5.6.14.5 Overcoming Deliberate Roadblocks to Using the Nonresident Alien Position

5.6.14.5.1 The deception that scares people away from claiming nonresident alien status
5.6.14.5.2 Tricks Congress Pulled to Undermine the Nonresident Alien Position
5.6.14.5.3 How to Avoid Jeopardizing Your Nonresident Citizen or Nonresident Alien Status
5.6.14.5.4 "Will I Lose My Military Security Clearance or Social Security Benefits by Becoming a Nonresident Alien or a 'U.S.

national'?"

5.6.14.6 Rebutted Objections to the Nonresident Alien Position

5.6.14.6.1 Tax, Accounting, and Legal Profession Objections
5.6.14.6.2 Objections of friends and family

5.6.14.6 How To Correct Government Records to Reflect Your True Status as a Nonresident Alien

5.6.15 All compensation for your personal labor is deductible from "gross income" on your tax return

5.6.15.1 Why One's Own Labor is not an article of Commerce and cannot produce "profit" in the Context of oneself
5.6.15.2 Why Labor is Property
5.6.15.3 Why the Cost of Labor is Deductible from Gross Receipts in Computing Tax

5.6.16 IRS Has no Authority to Convert a Tax Class 5 "gift" into a Tax Class 2 liability
5.6.17 The "Constitutional Rights Position"
5.6.18 The Internal Revenue Code was Repealed in 1939 and we have no tax law
5.6.19 Use of the term "State" in Defining State Taxing Jurisdiction
5.6.20 Why you aren't an "exempt" individual

5.7 Flawed Tax Arguments to Avoid

5.7.1 Summary of Flawed Arguments
5.7.2 Rebutted Version of the IRS Pamphlet "The Truth About Frivolous Tax Arguments"
5.7.3 Rebutter Version of Congressional Research Service Report 97-59A entitled "Frequently Asked Questions Concerning the Federal Income Tax"
5.7.4 Rebutter Version of Dan Evans "Tax Resister FAQ"
5.7.5 The "861 Source" Position

5.7.5.1 Introduction and definitions
5.7.5.2 The Basics of the Law
5.7.5.3 English vs. Legalese
5.7.5.4 Sources of Income
5.7.5.5 Determining Taxable Income
5.7.5.6 Specific Taxable Sources

5.7.5.6.1 Sources "within" the United States: Income Originating Inside the District of Columbia
5.7.5.6.2 Sources "without" the United States: Income Originating Inside the 50 states, territories and possessions, and Foreign Nations

5.7.5.7 Operative Sections
5.7.5.8 Summary of the 861 position
5.7.5.9 Why Hasn't The 861 Issue Been Challenged in Court Already?
5.7.5.10 Common IRS (and DOJ) objections to the 861/source issue with rebuttal

5.7.5.10.1 "We are all taxpayers. You can't get out of paying income tax because the law says you are liable."
5.7.5.10.2 IRC Section 861 falls under Subchapter N, Part I, which deals only with FOREIGN Income

5.7.5.10.3 "Section 861 says all income is taxable"
5.7.5.10.4 The Sixteenth Amendment says “from whatever source derived”…this means the source doesn’t matter!
5.7.5.10.5 “The courts have consistently ruled against th 861 issue”
5.7.5.10.6 “You are misunderstanding and misapplying the law and you’re headed for harm”
5.7.5.10.7 "Commissioner v. Glenshaw Glass Co. case makes the source of income irrelevant and taxes all 'sources'"
5.7.5.10.8 Frivolous Return Penalty Assessed by the IRS for those Using the 861 Position
5.7.5.10.9 The income tax is a direct, unapportioned tax on income, not an excise tax, so you still are liable for it

5.7.5.11 Why the 861 argument is subordinate to the jurisdictional argument

5.8 Considerations Involving Government Employment Income
5.9 So What Would Have to Be Done To the Constitution To Make Direct Income Taxes Legal?
5.10 Abuse of Legal Ignorance and Presumption: Weapons of tyrants

5.10.1 Application of "innocent until proven guilty" maxim of American Law
5.10.2 Role of Law and Presumption in Proving Guilt
5.10.3 Statutory Presumptions that Injure Rights are Unconstitutional
5.10.4 Purpose of Due Process: To completely remove "presumption" from legal proceedings
5.10.5 Application of "Expressio unius est exclusio alterius" rule
5.10.6 Scams with the Word "includes"
5.10.7 Guilty Until Proven Innocent: False Presumptions of Liability Based on Treacherous Definitions
5.10.8 Purpose of Vague Laws is to Chain you to IRS Control
5.10.9 Why the “Void for Vagueness Doctrine” of the U.S. Supreme Court Should be Invoked By The Courts to Render the Internal Revenue Code Unconstitutional

5.11 Other Clues and Hints At The Correct Application of the IRC

5.11.1 On the Record
5.11.2 Section 306
5.11.3 Strange Links
5.11.4 Following Instructions
5.11.5 Treasury Decision 2313
5.11.6 Other Clues
5.11.7 5 U.S.C., Section 8422: Deductions of OASDI for Federal Employees

5.12 How Can I Know When I've Discovered the Truth About Income Taxes?
5.13 How the Government exploits our weaknesses to manufacture "taxpayers"
5.14 Federal income taxes within territories and possessions of the United States
5.15 Congress has made you a Political "tax prisoner" and a "feudal serf" in your own country!
5.16 The Government's Real Approach Towards Tax Law

6. HISTORY OF FEDERAL GOVERNMENT INCOME TAX FRAUD, RACKETEERING AND EXTORTION IN THE U.S.A.

6.1 How Scoundrels Corrupted Our Republican Form of Government
6.2 General Evolution
6.3 The Laws of Tyranny
6.4 Presidential Scandals Related to Income Taxes and Socialism

6.4.1 1925: William H. Taft's Certiorari Act of 1925
6.4.2 1933: FDR's Great American Gold Robbery

6.4.2.1 Money Background
6.4.2.2 The Trading With the Enemy Act: Day the President Declared War on His Own People!
6.4.2.3 FDR's Gold Robbery Scam
6.4.2.4 FDR Defends the Federal Damn Reserve

6.4.3 1935: FDR's Socialist (Social) Security Act of 1935

6.4.3.1 FDR's Pep-Talk to Congress, January 17, 1935
6.4.3.2 FDR and the Birth of Social Security: Destroying Rugged Individuality

6.4.4 1937: FDR's Stacking of the Supreme Court
6.4.5 1943: FDR's Executive Order 9397: Bye-Bye Privacy and Fourth Amendment!

6.5 History of Congressional Cover-Ups and Tax Code Obfuscation

6.5.1 No Taxation Without Representation!
6.5.2 The Corruption of Our Tax System by the Courts and the Congress: Downes v. Bidwell, 182 U.S. 244, 1901
6.5.3 Why the Lawyers in Congress Just Love the Tax Code
6.5.4 Elements of the IRS Cover-Up/Conspiracy to Watch For
6.5.5 IRS Form 1040: Conspiracy by Congress to Violate Rights
6.5.6 Whistleblower Retaliation, Indifference, and Censorship

6.3.6.1 We the People Truth In Taxation Hearing, February 27-28, 2002
6.3.6.2 We the People Efforts: April 5, 2001 Senate Hearing
6.3.6.3 Cover-Up of Jan. 20, 2002: Congress/DOJ/IRS/ Renege on a Written Agreement to Hold a Truth in Taxation Hearing with We The People Under First Amendment

6.5.7 Cover-Up of 2002: 40 U.S.C. §255 Obfuscated
6.5.8 Cover-Up of 1988: Changed Title of Part I, Subchapter N to Make it Refer Only to Foreign Income
6.5.9 Cover-Up of 1986: Obfuscation of 26 U.S.C. §931
6.5.10 Cover-Up of 1982: Footnotes Removed from IRC Section 61 Pointing to Section 861
6.5.11 Cover-Up of 1978: Confused IRS Regulations on “Sources”
6.5.12 Cover-Up of 1954: Hiding of Constitutional Limitations On Congress’ Right To Tax
6.5.13 1952: Office of Collector of Internal Revenue Eliminated
6.5.14 Cover-Up of 1939: Removed References to Nonresident Aliens from the Definition of “Gross Income
6.5.15 1932: Revenue Act of 1932 imposes first excise income tax on federal judges and public officers
6.5.16 1918: "Gross income" first defined in the Revenue Act of 1918
6.5.17 1911: Judicial Code or 1911
6.5.18 1909: Corporate Excise Tax of 1909
6.5.19 1872: Office of the Assessor of Internal Revenue Eliminated
6.5.20 1862: First Tax on "Officers" of the U.S. Government

6.6 Treasury/IRS Cover-Ups, Obfuscation, and Scandals

6.6.1 Elements of the IRS Cover-Up/Conspiracy to Watch For
6.6.2 26 CFR 1.0-1: Publication of Internal Revenue Code WITHOUT Index

6.6.3 Official/Qualified Immunity and Anonymity
6.6.4 Church Censorship, Manipulation, and Castration by the IRS
6.6.5 IRS Form W-4 Scandals

6.5.5.1 Fraud on the W-4 Form
6.5.5.2 Unconstitutional IRS/Treasury Regulations

6.6.6 Illegal Treasury Regulation 26 CFR 301.6331-1
6.6.7 IRS Form 1040: Irrational Conspiracy to Violate Rights
6.6.8 IRS Form W-4 Scandals

6.6.8.1 Fraud on the W-4 Form
6.6.8.2 Unconstitutional IRS/Treasury Regulations Relating to the W-4
6.6.8.3 Line 3a of W-4 modifies and obfuscates 26 U.S.C. 3402(n)

6.6.9 Whistleblower Retaliation

6.6.9.1 IRS Historian Quits-Then Gets Audited
6.6.9.2 IRS Raided the Save-A-Patriot Fellowship

6.6.10 IRS has NO Delegated Authority to Impose Penalties or Levies or Seizures for Nonpayment of Subtitle A Personal Income Taxes

6.6.10.1 What Particular Type of Tax is Part 301 of IRS Regulations?
6.6.10.2 Parallel Table of Authorities 26 CFR to 26 U.S.C.

6.6.11 Service of Illegal Summons
6.6.12 IRS Publication 1: Taxpayer rights...Oh really?
6.6.13 Cover-Up of March 2004: IRS Removed List of Return Types Authorized for SFR from IRM Section 5.1.11.9
6.6.14 Cover-Up of Jan. 2002: IRS Removed the Internal Revenue Manual (IRM) from their Website Search Engine
6.6.15 W-8 Certificate of Foreign Status Form Removed from the IRS Website December 2000 and replaced with W-8 BEN
6.6.16 Cover-Up of 1999: IRS CID Agent Joe Banister Terminated by IRS For Discovering the Truth About Voluntary Nature of Income Taxes
6.6.17 Cover-Up of 1995: Modified Regulations to Remove Pointers to Form 2555 for IRC Section 1 Liability for Federal Income Tax
6.6.18 Cover-Up of 1993--HOT!!: IRS Removed References in IRS Publication 515 to Citizens Not Being Liable for Tax and Confused New Language

6.7 Department of State (DOS) Scandals Related to Income Taxes
6.8 Department of Justice Scandals Related to Income Taxes

6.8.1 Prosecution of Dr. Phil Roberts: Political "Tax" Prisoner
6.8.2 Fraud on The Court: Demjanuk v. Petrovsky, 10 F.3d 338

6.9 Judicial Conspiracy to Protect the Income Tax

6.9.1 Abuse of "Case Law"
6.9.2 The Federal Mafia Courts Stole Your Seventh Amendment Right to Trial by Jury!
6.9.3 You Cannot Obtain Declaratory Judgments in Federal Income Tax Trials Held In Federal Courts
6.9.4 The Changing Definition of “Direct, Indirect, and Excise Taxes”

6.9.4.1 Definition of terms and legal framework
6.9.4.2 The Early Supreme Court View of Direct vs. Indirect/Excise Taxes Prior to Passage of the 16th Amendment 1913
6.9.4.3 Common Manifestations of the Judicial Conspiracy
6.9.4.4 Judicial Conspiracy Following Passage of 16th Amendment in 1913
6.9.4.5 The Federal District Court Conspiracy to Protect the Income Tax
6.9.4.6 State Court Rulings

6.9.5 2003: Federal Court Ban's Irwin Schiff's Federal Mafia Tax book
6.9.6 2002: Definition for "Acts of Congress" removed from Federal Rules of Criminal Procedure
6.9.7 1992: William Conklin v. United States
6.9.8 1986: 16th Amendment: U.S. v. Stahl, 792 F.2d 1438 (1986)
6.9.9 1938: O'Malley v. Woodrough, 307 U.S. 277
6.9.10 1924: Miles v. Graham, 268 U.S. 601
6.9.11 1915: Brushaber v. Union Pacific Railroad, 240 U.S. 1
6.9.12 Conclusions

6.10 Legal Profession Scandals

6.10.1 Legal Dictionary Definitions of "United States"
6.10.2 The Taxability of Wages and Income Derived from "Labor" Rather than "Profit" as Described in CLE Materials

6.11 Social Security Chronology
6.12 Conclusion: The Duck Test

7. CASE STUDIES

7.1 An Epidemic of Non-Filers
7.2 Individuals

7.2.1 Joseph Banister: Former IRS Criminal Investigative Division (CID) Agent
7.2.2 Gaylon Harrell
7.2.5 Fred Allnut
7.2.6 Lloyd Long

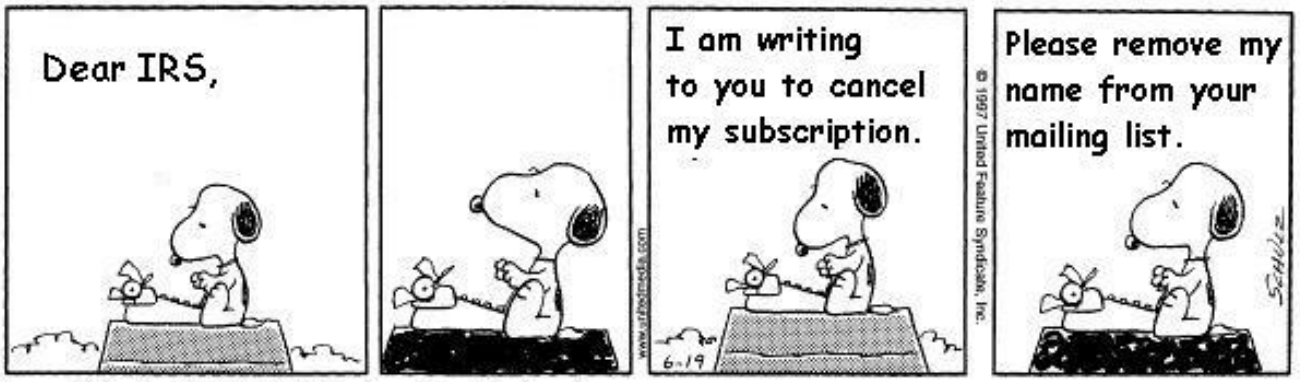
7.3 Employers

7.3.1 Arrow Custom Plastics Ends Withholding

8. RESOURCES FOR TAX FRAUD FIGHTERS

8.1 Websites
8.2 Books and Publications
8.3 Legal Resources

9. DEFINITIONS



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Socialism v. Capitalism: Which Is the Moral System

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Socialism vs. Capitalism: Which is the Moral System?

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by: C. Bradley Thompson

Throughout history there have been two basic forms of social organization: collectivism and individualism. In the twentieth-century collectivism has taken many forms: socialism, fascism, nazism, welfare-statism and communism are its more notable variations. The only social system commensurate with individualism is laissez-faire capitalism.

The extraordinary level of material prosperity achieved by the capitalist system over the course of the last two-hundred years is a matter of historical record. But very few people are willing to defend capitalism as morally uplifting.

It is fashionable among college professors, journalists, and politicians these days to sneer at the free-enterprise system. They tell us that capitalism is base, callous, exploitative, dehumanizing, alienating, and ultimately enslaving.

The intellectuals' mantra runs something like this: In theory socialism is the morally superior social system despite its dismal record of failure in the real world. Capitalism, by contrast, is a morally bankrupt system despite the extraordinary prosperity it has created. In other words, capitalism at best, can only be defended on pragmatic grounds. We tolerate it because it works.

Under socialism a ruling class of intellectuals, bureaucrats and social planners decide what people want or what is good for society and then use the coercive power of the State to regulate, tax, and redistribute the wealth of those who work for a living. In other words, socialism is a form of legalized theft.

The morality of socialism can be summed-up in two words: envy and self-sacrifice. Envy is the desire to not only possess another's wealth but also the desire to see another's wealth lowered to the level of one's own. Socialism's teaching on self-sacrifice was nicely summarized by two of its greatest defenders, Hermann Goering and Bennito Mussolini. The highest principle of Nazism (National Socialism), said Goering, is: "Common good comes before private good." Fascism, said Mussolini, is " a life in which the individual, through the sacrifice of his own private interests…realizes that completely spiritual existence in which his value as a man lies."

Socialism is the social system which institutionalizes envy and self-sacrifice: It is the social system which uses compulsion and the organized violence of the State to expropriate wealth from the producer class for its redistribution to the parasitical class.

Despite the intellectuals' psychotic hatred of capitalism, it is the only *moral* and *just* social system.

Capitalism is the only moral system because it requires human beings to deal with one another as traders--that is, as free moral agents trading and selling goods and services on the basis of mutual consent.

Capitalism is the only just system because the sole criterion that determines the value of thing exchanged is the free, voluntary, universal judgement of the consumer. Coercion and fraud are anathema to the free-market system.

It is both moral and just because the degree to which man rises or falls in society is determined by the degree to which he uses his mind. Capitalism is the only social system that rewards merit, ability and achievement, regardless of one's birth or station in life.

Yes, there are winners and losers in capitalism. The winners are those who are honest, industrious, thoughtful, prudent, frugal, responsible, disciplined, and efficient. The losers are those who are shiftless, lazy, imprudent, extravagant, negligent, impractical, and inefficient.

Capitalism is the only social system that rewards virtue and punishes vice. This applies to both the business executive and the carpenter, the lawyer and the factory worker.

But how does the entrepreneurial mind work? Have you ever wondered about the mental processes of the men and women who invented penicillin, the internal combustion engine, the airplane, the radio, the electric light, canned food, air conditioning, washing machines, dishwashers, computers, etc.?

What are the characteristics of the entrepreneur? The entrepreneur is that man or woman with unlimited drive, initiative, insight, energy, daring creativity, optimism and ingenuity. The entrepreneur is the man who sees in every field a potential garden, in every seed an apple. Wealth starts with ideas in people's heads.

The entrepreneur is therefore above all else a man of the mind. The entrepreneur is the man who is constantly thinking of new ways to improve the material or spiritual lives of the greatest number of people.

And what are the social and political conditions which encourage or inhibit the entrepreneurial mind? The free-enterprise system is not possible without the sanctity of private property, the freedom of contract, free trade and the rule of law.

But the one thing that the entrepreneur values over all others is freedom--the freedom to experiment, invent and produce. The one thing that the entrepreneur dreads is government intervention. Government taxation and regulation are the means by which social planners punish and restrict the man or woman of ideas.

Welfare, regulations, taxes, tariffs, minimum-wage laws are all immoral because they use the coercive power of the state to organize human choice and action; they're immoral because they inhibit or deny the freedom to choose how we live our lives; they're immoral because they deny our right to live as autonomous moral agents; and they're immoral because they deny our essential humanity. If you think this is hyperbole, stop paying your taxes for a year or two and see what happens.

The requirements for success in a free society demand that ordinary citizens order their lives in accordance with certain virtues--namely, rationality, independence, industriousness, prudence, frugality, etc. In a free capitalist society individuals must choose for themselves how they will order their lives and the values they will pursue. Under socialism, most of life's decisions are made for you.

Both socialism and capitalism have incentive programs. Under socialism there are built-in incentives to shirk responsibility. There is no reason to work harder than anyone else becuase the rewards are shared and therefore minimal to the hard-working individual; indeed, the incentive is to work less than others because the immediate loss is shared and therefore minimal to the slacker.

Under capitalism, the incentive is to work harder because each producer will receive the total value of his production--the rewards are not shared. Simply put: socialism rewards sloth and penalizes hard work while capitalism rewards hard work and penalizes sloth.

According to socialist doctrine, there is a limited amount of wealth in the world that must be divided equally between all citizens. One person's gain under such a system is another's loss.

According to the capitalist teaching, wealth has an unlimited growth potential and the fruits of one's labor should be retained in whole by the producer. But unlike socialism, one person's gain is everybody's gain in the capitalist system. Wealth is distributed unequally but the ship of wealth rises for everyone.

Sadly, America is no longer a capitalist nation. We live under what is more properly called a mixed economy--that is, an economic system that permits private property, but only at the discretion of government planners. A little bit of capitalism and a little bit of socialism.

When government redistributes wealth through taxation, when it attempts to control and regulate business production and trade, who are the winners and losers? Under this kind of economy the winners and losers are reversed: the winners are those who scream the loudest for a handout and the losers are those quiet citizens who work hard and pay their taxes.

As a consequence of our sixty-year experiment with a mixed economy and the welfare state, America has created two new classes of citizens. The first is a debased class of dependents whose means of survival is contingent upon the forced expropriation of wealth from working citizens by a professional class of government social planners. The forgotten man and woman in all of this is the quiet, hardworking, lawabiding, taxpaying citizen who minds his or her own business but is forced to work for the government and their serfs.

The return of capitalism will not happen until there is a moral revolution in this country. We must rediscover and then teach our young the virtues associated with being free and independent citizens. Then and only then, will there be social justice in America.

C. Bradley Thompson is Assistant Professor of Political Science at Ashland University and Coordinator of Publications and Special Programs at the John M. Ashbrook Center for Public Affairs.

§ 6012. Persons required to make returns of income

(a) General rule

Returns with respect to income taxes under subtitle A shall be made by the following:

(1)

(A) Every individual having for the taxable year gross income which equals or exceeds the exemption amount, except that a return shall not be required of an individual—

(i) who is not married (determined by applying section 7703), is not a surviving spouse (as defined in section 2 (a)), is not a head of a household (as defined in section 2 (b)), and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(ii) who is a head of a household (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(iii) who is a surviving spouse (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual, or

(iv) who is entitled to make a joint return and whose gross income, when combined with the gross income of his spouse, is, for the taxable year, less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint

return, but only if such individual and his spouse, at the close of the taxable year, had the same household as their home.

Clause (iv) shall not apply if for the taxable year such spouse makes a separate return or any other taxpayer is entitled to an exemption for such spouse under section 151 (c).

(B) The amount specified in clause (i), (ii), or (iii) of subparagraph (A) shall be increased by the amount of 1 additional standard deduction (within the meaning of section 63 (c)(3)) in the case of an individual entitled to such deduction by reason of section 63 (f)(1)(A) (relating to individuals age 65 or more), and the amount specified in clause (iv) of subparagraph (A) shall be increased by the amount of the additional standard deduction for each additional standard deduction to which the individual or his spouse is entitled by reason of section 63 (f)(1).

(C) The exception under subparagraph (A) shall not apply to any individual—

(i) who is described in section 63 (c)(5) and who has—

(I) income (other than earned income) in excess of the sum of the amount in effect under section 63 (c)(5)(A) plus the additional standard deduction (if any) to which the individual is entitled, or

(II) total gross income in excess of the standard deduction, or

(ii) for whom the standard deduction is zero under section 63 (c)(6).

(D) For purposes of this subsection—

(i) The terms "standard deduction", "basic standard deduction" and "additional standard deduction" have the respective meanings given such terms by section 63 (c).

(ii) The term "exemption amount" has the meaning given such term by section 151 (d). In the case of an individual described in section 151 (d)(2), the exemption amount shall be zero.

(2) Every corporation subject to taxation under subtitle A;

(3) Every estate the gross income of which for the taxable year is $600 or more;

(4) Every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income;

(5) Every estate or trust of which any beneficiary is a nonresident alien;

(6) Every political organization (within the meaning of section 527 (e)(1)), and every fund treated under section 527 (g) as if it constituted a political organization, which has political organization taxable income (within the meaning of section 527 (c)(1)) for the taxable year; and [1]

(7) Every homeowners association (within the meaning of section 528 (c)(1)) which has homeowners association taxable income (within the meaning of section 528 (d)) for the taxable year.[1]

(8) Every individual who receives payments during the calendar year in which the taxable year begins under section 3507 (relating to advance

payment of earned income credit).[1]

(9) Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under section 63 (c)(2)(D).[1], [2]

except that subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary, nonresident alien individuals subject to the tax imposed by section 871 and foreign corporations subject to the tax imposed by section 881 may be exempted from the requirement of making returns under this section.

(b) Returns made by fiduciaries and receivers

(1) Returns of decedents

If an individual is deceased, the return of such individual required under subsection (a) shall be made by his executor, administrator, or other person charged with the property of such decedent.

(2) Persons under a disability

If an individual is unable to make a return required under subsection (a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.

(3) Receivers, trustees and assignees for corporations

In a case where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

(4) Returns of estates and trusts

Returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

(5) Joint fiduciaries

Under such regulations as the Secretary may prescribe, a return made by one of two or more joint fiduciaries shall be sufficient compliance with the requirements of this section. A return made pursuant to this paragraph shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(6) IRA share of partnership income

In the case of a trust which is exempt from taxation under section 408 (e), for purposes of this section, the trust's distributive share of items of gross income and gain of any partnership to which subchapter C or D of chapter 63 applies shall be treated as equal to the trust's distributive share of the taxable income of such partnership.

(c) Certain income earned abroad or from sale of residence

For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 121 (relating to gain from sale of principal residence) and without regard to the exclusion provided for in section 911 (relating to citizens or residents of the United States living abroad).

(d) Tax-exempt interest required to be shown on return

Every person required to file a return under this section for the taxable year shall include on such return the amount of interest received or accrued during the taxable year which is exempt from the tax imposed by chapter 1.

(e) Consolidated returns

For provisions relating to consolidated returns by affiliated corporations, see chapter 6.

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[1] So in original.

[2] See References in Text note below.

Prev | Next

§ 61. Gross income defined

How Current is This?

(a) General definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) Cross references

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

Prev | Next

Sec. 61. - Gross income defined

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Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2)

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(3)

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(6)

Royalties;

(7)

Dividends;

(8)

Alimony and separate maintenance payments;

(9)

Annuities;

(10)

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(11)

Pensions;

(12)

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(13)

Distributive share of partnership gross income;

(14)

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Income from an interest in an estate or trust.

(b)

Cross references For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following)

Next

Sec. 6012. - Persons required to make returns of income

(a) General rule

Returns with respect to income taxes under subtitle A shall be made by the following:

(1)

(A)

Every individual having for the taxable year gross income which equals or exceeds the exemption amount, except that a return shall not be required of an individual -

(i)

who is not married (determined by applying section 7703), is not a surviving spouse (as defined in section 2(a)), is not a head of a household (as defined in section 2(b)), and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(ii)

who is a head of a household (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(iii)

who is a surviving spouse (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an

Search this title:

Search Title 26

Notes
Updates
Parallel authorities (CFR)
Topical references

individual, or

(iv)

who is entitled to make a joint return and whose gross income, when combined with the gross income of his spouse, is, for the taxable year, less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, but only if such individual and his spouse, at the close of the taxable year, had the same household as their home.

Clause (iv) shall not apply if for the taxable year such spouse makes a separate return or any other taxpayer is entitled to an exemption for such spouse under section 151(c).

(B)

The amount specified in clause (i), (ii), or (iii) of subparagraph (A) shall be increased by the amount of 1 additional standard deduction (within the meaning of section 63(c)(3)) in the case of an individual entitled to such deduction by reason of section 63(f)(1)(A) (relating to individuals age 65 or more), and the amount specified in clause (iv) of subparagraph (A) shall be increased by the amount of the additional standard deduction for each additional standard deduction to which the individual or his spouse is entitled by reason of section 63(f)(1).

(C)

The exception under subparagraph (A) shall not apply to any individual -

(i)

who is described in section 63(c)(5) and who has -

(I)

income (other than earned income) in excess of the sum of the amount in effect under section 63(c)(5)(A) plus the additional standard deduction (if any) to which the individual is entitled, or

(II)

total gross income in excess of the standard deduction, or

(ii)

for whom the standard deduction is zero under section 63(c)(6).

(D)

For purposes of this subsection -

(i)

The terms ''standard deduction'', ''basic standard deduction'' and ''additional standard deduction'' have the respective meanings given such terms by section 63(c).

(ii)

The term ''exemption amount'' has the meaning given such term by section 151(d). In the case of an individual described in section 151(d)(2), the exemption amount shall be zero.

(2)

Every corporation subject to taxation under subtitle A;

(3)

Every estate the gross income of which for the taxable year is $600 or more;

(4)

Every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income;

(5)

Every estate or trust of which any beneficiary is a nonresident alien;

(6)

Every political organization (within the meaning of section 527(e)(1)), and every fund treated under section 527(g) as if it constituted a political organization, which has political organization taxable income (within the meaning of section 527(c)(1)) for the taxable year or which has gross receipts of $25,000 or more for the taxable year (other than an organization to which section 527 applies solely by reason of subsection (f)(1) of such section); and [1] (FOOTNOTE 1) So in original.

(7)

Every homeowners association (within the meaning of section 528(c)(1)) which has homeowners association taxable income (within the meaning of section 528(d)) for the taxable year.

(8)

Every individual who receives payments during the calendar year in which the taxable year begins under section 3507 (relating to advance payment of earned income credit). (FOOTNOTE 1)

(9)

Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under section 63(c)(2)(D). [1] except that subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary, nonresident alien individuals subject to the tax imposed by section 871 and foreign corporations subject to the tax imposed by section 881 may be exempted from the requirement of making returns under this section.

(b) Returns made by fiduciaries and receivers

(1) Returns of decedents

If an individual is deceased, the return of such individual required under subsection (a) shall be made by his executor, administrator, or other person charged with the property of such decedent.

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If an individual is unable to make a return required under subsection (a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.

(3) Receivers, trustees and assignees for corporations

In a case where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law

or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

(4) Returns of estates and trusts

Returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

(5) Joint fiduciaries

Under such regulations as the Secretary may prescribe, a return made by one of two or more joint fiduciaries shall be sufficient compliance with the requirements of this section. A return made pursuant to this paragraph shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(6) IRA share of partnership income

In the case of a trust which is exempt from taxation under section 408(e), for purposes of this section, the trust's distributive share of items of gross income and gain of any partnership to which subchapter C or D of chapter 63 applies shall be treated as equal to the trust's distributive share of the taxable income of such partnership.

(c) Certain income earned abroad or from sale of residence

For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 121 (relating to gain from sale of principal residence) and without regard to the exclusion provided for in section 911 (relating to citizens or residents of the United States living abroad).

(d) Tax-exempt interest required to be shown on return

Every person required to file a return under this section for the taxable year shall include on such return the amount of interest received or accrued during the taxable year which is exempt from the tax imposed by chapter 1.

(e)

Consolidated returns

For provisions relating to consolidated returns by affiliated corporations, see chapter 6

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Next

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THOMSON FINDLAW

U.S. Supreme Court

EISNER v. MACOMBER , 252 U.S. 189 (1920)

252 U.S. 189

EISNER, Internal Revenue Collector,
v.
MACOMBER.
No. 318.

Argued April 16, 1919

Restored to Docket for Reargument, May 19, 1919.

Reargued Oct. 17 and 20, 1919.
Decided March 8, 1920.

[252 U.S. 189, 190] Mr. Assistant Attorney General Frierson, for plaintiff in error.

[252 U.S. 189, 194] Messrs. Charles E. Hughes and George Welwood Murray, both of New York City, for defendant in error.

[252 U.S. 189, 199]

Mr. Justice PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916 (39 Stat. 756 et seq., c. 463 [Comp. St. 6336a et seq.]), which, in our opinion (notwithstanding a contention of the government that will be [252 U.S. 189, 200] noticed), plainly evinces the purpose of Congress to tax stock dividends as income. 1

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000, 000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent. of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional [252 U.S. 189, 201] shares, of which 18.07 per cent., or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $ 19,877 because of the new shares; and an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated article 1, 2, cl. 3, and article 1, 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. A general demurrer to the complaint was overruled upon the authority of Towne v. Eisner, 245 U.S. 418 , 38 Sup. Ct. 158, L. R. A. 1918D, 254; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

The case was argued at the last term, and reargued at the present term, both orally and by additional briefs.

We are constrained to hold that the judgment of the District Court must be affirmed: First, because the question at issue is controlled by Towne v. Eisner, supra; secondly, because a re-examination of the question with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.

In Towne v. Eisner, the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913 (38 Stat. 114, 166, c. 16), which provided (section B, p. 167) that net income should include 'dividends,' and also 'gains or profits and income derived [252 U.S. 189, 202] from any source whatever.' Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the District Court sustained a demurrer to the complaint. 242 Fed. 702. The court treated the construction of the act as inseparable from the interpretation of the Sixteenth Amendment; and, having referred to Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 , 15 Sup. Ct. 912, and quoted the Amendment, proceeded very properly to say (242 Fed. 704):

> 'It is manifest that the stock dividend in question cannot be reached by the Income Tax Act and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income.'

It declined, however, to accede to the contention that in Gibbons v. Mahon, 136 U.S. 549 , 10 Sup. Ct. 1057, 'stock dividends' had received a definition sufficiently clear to be controlling, treated the language of this court in that case as obiter dictum in respect of the matter then before it (242 Fed. 706), and examined the question as res nova, with the result stated. When the case came here, after overruling a motion to dismiss made by the government upon the ground that the only question involved was the construction of the statute and not its constitutionality, we dealt upon the merits with the question of construction only, but disposed of it upon consideration of the essential nature of a stock dividend disregarding the fact that the one in question was based upon surplus earnings that accrued before the Sixteenth Amendment took effect. Not only so, but we rejected the reasoning of the District Court, saying (245 U.S. 426 , 38 Sup. Ct. 159, L. R. A. 1918D, 254):

> 'Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the [252 U.S. 189, 203] interests of the shareholders. Its property is not diminished, and their interests are not increased. ... The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons v. Mahon, 136 U.S. 549, 559 , 560 S. [10 Sup. Ct. 1057]. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County v. United States, 169 U.S. 255 , 261 [18 Sup. Ct. 361]. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. ... What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.'

This language aptly answered not only the reasoning of the District Court but the argument of the Solicitor General in this court, which discussed the essential nature of a stock dividend. And if, for the reasons thus expressed, such a dividend is not to be regarded as 'income' or 'dividends' within the meaning of the act of 1913, we are unable to see how it can be brought within the meaning of 'incomes' in the Sixteenth Amendment; it being very clear that Congress intended in that act to exert its power to the extent permitted by the amendment. In Towne v. Eisner it was not contended that any construction of the statute could make it narrower than the constitutional grant; rather the contrary.

The fact that the dividend was charged against profits earned before the act of 1913 took effect, even before the amendment was adopted, was neither relied upon nor alluded to in our consideration of the merits in that case. Not only so, but had we considered that a stock dividend constituted income in any true sense, it would have been held taxable under the act of 1913 notwithstanding it was [252 U.S. 189, 204] based upon profits earned before the amendment. We ruled at the same term, in Lynch v. Hornby, 247 U.S. 339 , 38 Sup. Ct. 543, that a cash dividend extraordinary in amount, and in Peabody v. Eisner, 247 U.S. 347 , 38 Sup. Ct. 546, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the amendment. In the former case, concerning 'corporate profits that accumulated before the act took effect,' we declared (247 U.S. 343, 344 , 38 S. Sup. Ct. 543, 545 [62 L. Ed. 1149]):

> 'Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. ... Congress was at liberty under the amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing.'

In Peabody v. Eisner, 247 U.S. 349, 350 , 38 S. Sup. Ct. 546, 547 (62 L. Ed. 1152), we observed that the decision of the District Court in Towne v. Eisner had been reversed 'only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest,' and we distinguished the Peabody Case from the Towne Case upon the ground that 'the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution in specie of a portion of the assets of the Union Pacific.'

Therefore Towne v. Eisner cannot be regarded as turning [252 U.S. 189, 205] upon the point that the surplus accrued to the company before the act took effect and before adoption of the amendment. And what we have quoted from the opinion in that case cannot be regarded as obiter dictum, it having furnished the entire basis for the conclusion reached. We adhere to the view then expressed, and might rest the present case there, not because that case in terms decided the constitutional question, for it did not, but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.

Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. 757 [Comp. St . 6336b]) that a 'stock dividend shall be considered income, to the amount of its cash value,' we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.

The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 , 15 Sup. Ct. 912, under the Act of August 27, 1894 (28 Stat. 509, 553, c. 349, 27), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by article 1, 2, cl. 3, and section 9, cl. 4, of the original Constitution.

Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished:

> 'The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among [252 U.S. 189, 206] the several states, and without regard to any census or enumeration.'

As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the

necessity which otherwise might exist for an apportionment among the states of taxes laid on income. Brushaber v. Union Pacific R. R. Co., 240 U.S. 1 , 17-19, 36 Sup. Ct. 236, Ann. Cas. 1917B, 713, L. R. A. 1917D, 414; Stanton v. Baltic Mining Co., 240 U.S. 103 , 112 et seq., 36 Sup. Ct. 278; Peck & Co. v. Lowe, 247 U.S. 165, 172 , 173 S., 38 Sup. Ct. 432.

A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' [252 U.S. 189, 207] as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton's Independence v. Howbert, 231 U.S. 399, 415 , 34 S. Sup. Ct. 136, 140 [58 L. Ed. 285]; Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 , 38 S. Sup. Ct. 467, 469 [62 L. Ed. 1054]), 'Income may be defined as 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, to which it was applied in the Doyle Case, 247 U.S. 183, 185 , 38 S. Sup. Ct. 467, 469 (62 L. Ed. 1054).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived-from- capital'; 'the gain-derived-from-capital,' etc. Here we have the essential matter: not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived'-that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal- that is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment-'incomes, from whatever source derived'-the essential thought being expressed [252 U.S. 189, 208] with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or par value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself [252 U.S. 189, 209] from the company he can do so only by disposing of his stock.

For bookeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a 'capital stock account.' If profits have been made and not divided they create additional bookkeeping liabilities under the head of 'profit and loss,' 'undivided profits,' 'surplus account,' or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, [252 U.S. 189, 210] quipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar-by declaring a 'stock dividend.' This, however, is no more

than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed 'dividend'; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the 'liability' acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing 'capital stock' at the expense of [252 U.S. 189, 211] 'SURPLUS'; IT DOES NOT ALTER THE PRE-EXisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has recived nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

Being concerned only with the true character and effect of such a dividend when lawfully made, we lay aside the question whether in a particular case a stock dividend may be authorized by the local law governing the corporation, or whether the capitalization of profits may be the result of correct judgment and proper business policy on the part of its management, and a due regard for the interests of the stockholders. And we are considering the taxability of bona fide stock dividends only. [252 U.S. 189, 212] We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority

stockholder, having six-fifteenths instead of six- tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power-that 'right preservative of rights' in the control of a corporation. [252 U.S. 189, 213] Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

Throughout the argument of the government, in a variety of forms, runs the fundamental error already mentioned-a failure to appraise correctly the force of the term 'income' as used in the Sixteenth Amendment, or at least to give practical effect to it. Thus the government contends that the tax 'is levied on income derived from corporate earnings,' when in truth the stockholder has 'derived' nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings 'are received by the stockholder,' whereas he has received none; that the profits are 'distributed by means of a stock dividend,' although a stock dividend distributes no profits; that under the act of 1916 'the tax is on the stockholder's share in corporate earnings,' when in truth a stockholder has no such share, and receives none in a stock dividend; that 'the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains,' whereas there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent-a capital interest in the entire concerns of the corporation.

We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, [252 U.S. 189, 214] we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners, when they are not such, treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend-even one paid in money or property-can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends extent to which the gains accumulated by the extend to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value [252 U.S. 189, 215] of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values-a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.

The government's reliance upon the supposed analogy between a dividend of the corporation's own shares and one made by distributing shares owned by it in the stock of another company, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not, and for no citation of authority except Peabody v. Eisner, 247 U.S. 347, 349 , 350 S., 38 Sup. Ct. 546.

Two recent decisions, proceeding from courts of high jurisdiction, are cited in support of the position of the government. [252 U.S. 189, 216] Swan Brewery Co., Ltd. v. Rex, [252 U.S. 189, 1914] A. C. 231, arose under the Dividend Duties Act of Western Australia, which provided that 'dividend' should include 'every dividend, profit, advantage, or gain intended to be paid or credited to or distributed among any members or directors of any company,' except, etc. There was a stock dividend, the new shares being allotted among the shareholders pro rata; and the question was whether this was a distribution of a dividend within the meaning of the act. The Judicial Committee of the Privy Council sustained the dividend duty upon the ground that, although 'in ordinary language the new shares would not be called a dividend, nor would the allotment of them be a distribution of a dividend,' yet, within the meaning of the act, such new shares were an 'advantage' to the recipients. There being no constitutional restriction upon the action of the lawmaking body, the case presented merely a question of statutory construction, and manifestly the decision is not a precedent for the guidance of this court when acting under a duty to test an act of Congress by the limitations of a written Constitution having superior force.

In Tax Commissioner v. Putnam (1917) 227 Mass. 522, 116 N. E. 904, L. R. A. 1917F, 806, it was held that the Forty-Fourth amendment to the Constitution of Massachusetts, which conferred upon the Legislature full power to tax incomes, 'must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income' (227 Mass. 526, 531, 116 N. E. 904, 907 [L. R. A. 1917F, 806]), and that under it a stock dividend was taxable as income; the court saying (227 Mass. 535, 116 N. E. 911, L. R. A. 1917F, 806):

> 'In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares.' [252 U.S. 189, 217] We cannot accept this reasoning. Evidently, in order to give a sufficiently broad sweep to the new taxing provision, it was deemed necessary to take the symbol for the substance, accumulation for distribution, capital accretion for its opposite; while a case where money is paid into the hand of the stockholder with an option to buy

> new shares with it, followed by acceptance of the option, was regarded as identical in substance with a case where the stockholder receives no money and has no option. The Massachusetts court was not under an obligation, like the one which binds us, of applying a constitutional amendment in the light of other constitutional provisions that stand in the way of extending it by construction.

Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, supra, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that by the true construction of the act of 1916 the tax is imposed, not upon the stock dividend, but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question, and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

The government relies upon Collector v. Hubbard (1870) [252 U.S. 189, 218] 12 Wall. 1, (20 L. Ed. 272), which arose under section 117 of the Act of June 30, 1864 (13 Stat. 223, 282, c. 173), providing that--

> 'The gains and profits of all companies, whether incorporated or partnership, other than the companies specified in that section, shall be included in estimating the annual gains, profits, or income of any person, entitled to the same, whether divided or otherwise.'

The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (12 Wall. 18):

> 'Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees.'

In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 627 , 628 S., 637, 15 Sup. Ct. 912. Conceding Collector v. Hubbard was inconsistent with the doctrine of that case, because it sustained a direct tax upon property not apportioned [252 U.S. 189, 219] AMONG THE STATES, THE GOVERNMENT NEVERTHEless insists that the sixteenth Amendment removed this obstacle, so that now the Hubbard Case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument

must be rejected, since the amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

Thus, from every point of view we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, 2, cl. 3, and article 1, 9, cl. 4, of the Constitution, and to this extent is invalid, notwithstanding the Sixteenth Amendment.

Judgment affirmed.

Mr. Justice HOLMES, dissenting.

I think that Towne v. Eisner, 245 U.S. 418 , 38 Sup. Ct. 158, L. R. A. 1918D, 254, was right in its reasoning and result and that on sound principles the stock dividend was not income. But it was clearly intimated in that case that the construction of the statute then before the Court might be different from that of the Constitution. 245 U.S. 425 , 38 Sup. Ct. 158, L. R. A. 1918D, 254. I think that the word 'incomes' in the Sixteenth Amendment should be read in [252 U.S. 189, 220] 'a sense most obvious to the common understanding at the time of its adoption.' Bishop v. State, 149 Ind. 223, 230, 48 N. E. 1038, 1040, 39 L. R. A. 278, 63 Am. St. Rep. 270; State v. Butler, 70 Fla. 102, 133, 69 South. 771. For it was for public adoption that it was proposed. McCulloch v. Maryland, 4 Wheat. 316, 407. The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. See Tax Commissioner v. Putnam, 227 Mass. 522, 532, 533, 116 N. E. 904, L. R. A. 1917F, 806.

Mr. Justice DAY concurs in this opinion.

Mr. Justice BRANDEIS delivered the following [dissenting] opinion:

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. .arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and, at the same time, for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to [252 U.S. 189, 221] the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a chsh dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend. How these two methods have been employed may be illustrated by the action in this respect (as reported in Moody's Manual, 1918 Industrial, and the Commercial and Financial Chronicle) of some of the Standard Oil companies, since the disintegration pursuant to the decision of this court in 1911. Standard Oil Co. v. United States, 221 U.S. 1 , 31 Sup. Ct. 502, 34 L. R. A. (N. S.) 834, Ann. Cas. 1912D, 734.

(a) Standard Oil Co. (of Indiana), an Indiana corporation. It had on December 31, 1911, $1,000,000 capital stock (all common), and a large surplus. On May 15, [252 U.S. 189, 222] 1912, it increased its capital stock to $30,000,000, and paid a simple stock dividend of 2,900 per cent. in stock. 2

(b) Standard Oil Co. (of Nebraska), a Nebraska corporation. It had on December 31, 1911, $600,000 capital stock (all common), and a substantial surplus. On April 15, 1912, it paid a simple stock dividend of 33 1/3 per cent., increasing the outstanding capital to $800,000. During the calendar year 1912 it paid cash dividends aggregating 20 per cent., but it earned considerably more, and had at the close of the year again a substantial surplus. On June 20, 1913, it declared a further stock dividend of 25 per cent., thus increasing the capital to $1,000,000.3

(c) The Standard Oil Co. (of Kentucky), a Kentucky corporation. It had on December 31, 1913, $1,000,000 capital stock (all common) and $3,701, 710 surplus. Of this surplus $902,457 had been earned during the calendar year 1913, the net profits of that year having been $1,002,457 and the dividends paid only $100,000 (10 per cent.). On December 22, 1913, a cash dividend of $200 per share was declared payable on February 14, 1914, to stockholders of record January 31, 1914, and these stockholders were offered the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor. The outstanding stock was thus increased to $3,000,000. During the calendar years 1914, 1915, and 1916, quarterly dividends were paid on this stock at an annual rate of between 15 per cent. and 20 per cent., but the company's surplus increased by $2,347,614, so that on December 31, 1916, it had a large surplus over its $3,000,000 capital stock. On December 15, 1916, the company issued a circular to the stockholders, saying:

> 'The company's business for this year has shown a [252 U.S. 189, 223] very good increase in volume and a proportionate increase in profits, and it is estimated that by January 1, 1917, the company will have a surplus of over $4,000,000. The board feels justified in stating that if the proposition to increase the capital stock is acted on favorably, it will be proper in the near future to declare a cash dividend of 100 per cent. and to allow the stockholders the privilege pro rata according to their holdings, to purchase the new stock at par, the plan being to allow the stockholders, if they desire, to use their cash dividend to pay for the new stock.'

The increase of stock was voted. The company then paid a cash dividend of 100 per cent., payable May 1, 1917, again offering to such stockholders the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor.

Moody's Manual, describing the transaction with exactness, says first that the stock was increased from $3,000,000 to $6,000,000, 'a cash dividend of 100 per cent., payable May 1, 1917, being exchanged for one share of new stock, the equivalent of a 100 per cent. stock dividend.' But later in the report giving,

as customary in the Manual the dividend record of the company, the Manual says: 'A stock dividend of 200 per cent. was paid February 14, 1914, and one of 100 per cent. on May 1, 1197.' And in reporting specifically the income account of the company for a series of years ending December 31, covering net profits, dividends paid and surplus for the year, it gives, as the aggregate of dividends for the year 1917, $ 660,000 (which was the aggregate paid on the quarterly cash dividend-5 per cent. January and April; 6 per cent. July and October), and adds in a note: 'In addition a stock dividend of 100 per cent. was paid during the year.' 4 The Wall Street Journal of [252 U.S. 189, 224] May 2, 1917, p. 2, quotes the 1917 'high' price for Standard Oil of Kentucky as '375 ex stock dividend.'

It thus appears that among financiers and investors the distribution of the stock, by whichever method effected, is called a stock dividend; that the two methods by which accumulated profits are legally retained for corporate purposes and at the same time distributed as dividends are recognized by them to be equivalents; and that the financial results to the corporation and to the stockholders of the two methods are substantially the same-unless a difference results from the application of the federal Income Tax Law.

Mrs. Macomber, a citizen and resident of New York, was, in the year 1916, a stockholder in the Standard Oil Company (of California), a corporation organized under the laws of California and having its principal place of business in that state. During that year she received from the company a stock dividend representing profits earned since March 1, 1913. The dividend was paid by direct issue of the stock to her according to the simple method described above, pursued also by the Indiana and Nebraska companies. In 1917 she was taxed under the federal law on the stock dividend so received at its par value of $100 a share, as income received during the year 1916. Such a stock dividend is income, as distinguished from capital, both under the law of New York and under the law of California, because in both states every dividend representing profits is deemed to be income, whether paid in cash or in stock. It had been so held in New York, where the question arose as between life tenant and remainderman, Lowry v. Farmers' Loan & Trust Co., 172 N. Y. 137, 64 N. E. 796; Matter of Osborne, 209 N. Y. 450, 103 N. E. 723, 823, 50 L. R. A. (N. S.) 510, Ann.Cas. 1915A, 298; and also, where the question arose in matters of taxation, People v. Glynn, [252 U.S. 189, 225] 130 App. Div. 332, 114 N. Y. Supp. 460; Id. 198 N. Y. 605, 92 N. E. 1097. It has been so held in California, where the question appears to have arisen only in controversies between life tenant and remainderman. Estate of Duffill, 183 Pac. 337.

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky; that is, issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased-the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income.

The Sixteenth Amendment, proclaimed February 25, 1913, declares:

> '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.'

The Revenue Act of September 8, 1916, c. 463, 2a, 39 Stat. 756, 757, provided:

> 'That the term 'dividends' as used in this title shall [252 U.S. 189, 226] be held to mean any distribution made or ordered to be made by a corporation, ... out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, ... which stock dividend shall be considered income, to the amount of its cash value.'

Hitherto powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power the substance of the transaction, not its form has been regarded. Martin v. Hunter, 1 Wheat, 304, 326; McCulloch v. Maryland, 4 Wheat. 316, 407, 415; Brown v. Maryland, 12 Wheat. 419, 446; Craig v. Missouri, 4 Pet. 410, 433; Jarrolt v. Moberly, 103 U.S. 580, 585 , 587 S.; Legal Tender Case, 110 U.S. 421, 444 , 4 S. Sup. Ct. 122; Lithograph Co. v. Sarony, 111 U.S. 53, 58 , 4 S. Sup. Ct. 279; United States v. Realty Co., 163 U.S. 427, 440 , 441 S., 442, 16 Sup. Ct. 1120; South Carolina v. United States, 199 U.S. 437, 448 , 449 S., 26 Sup. Ct. 110, 4 Ann. Cas. 737. Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?

First. The term 'income,' when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. If the [252 U.S. 189, 227] dividend is declared payable in cash, the money with which to pay it is ordinarily taken from surplus cash in the treasury. But (if there are profits legally available for distribution and the law under which the company was incorporated so permits) the company may raise the money by discounting negotiable paper; or by selling bonds, scrip or stock of another corporation then in the treasury; or by selling its own bonds, scrip or stock then in the treasury; or by selling its own bonds, scrip or stock issued expressly for that purpose. How the money shall be raised is wholly a matter of financial management. The manner in which it is raised in no way affects the question whether the dividend received by the stockholder is income or capital; nor can it conceivably affect the question whether it is taxable as income.

Likewise whether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management whether the distribution shall be, for instance, in bonds, scrip or stock of another corporation or in issues of its own. And if the dividend is paid in its own issues, why should there be a difference in result dependent upon whether the distribution was made from such securities then in the treasury or from others to be created and issued by the company expressly for that purpose? So far as the distribution may be made from its own issues of bonds, or preferred stock created expressly for the purpose, it clearly would make no difference in the decision of the question whether the dividend was a distribution of profits, that the securities had to be created expressly for the purpose of distribution. If a dividend paid in securities of that nature represents a distribution of profits Congress may, of course, tax it as income of the stockholder. Is the result different where the security distributed is common stock? [252 U.S. 189, 228] Suppose that a corporation having power to buy and sell its own stock, purchases, in the interval between its regular dividend dates, with moneys derived from current profits, some of its own common stock as a temporary

investment, intending at the time of purchase to sell it before the next dividend date and to use the proceeds in paying dividends, but later, deeming it inadvisable either to sell this stock or to raise by borrowing the money necessary to pay the regular dividend in cash, declares a dividend payable in this stock; can any one doubt that in such a case the dividend in common stock would be income of the stockholder and constitutionally taxable as such? See Green v. Bissell, 79 Conn. 547, 65 Atl. 1056, 8 L. R. A. (N. S.) 1011, 118 Am. St. Rep. 156, 9 Ann. Cas. 287; Leland v. Hayden, 102 Mass. 542. And would it not likewise be income of the stockholder subject to taxation if the purpose of the company in buying the stock so distributed had been from the beginning to take it off the market and distribute it among the stockholders as a dividend, and the company actually did so? And proceeding a short step further: Suppose that a corporation decided to capitalize some of its accumulated profits by creating additional common stock and selling the same to raise working capital, but after the stock has been issued and certificates therefor are delivered to the bankers for sale, general financial conditions make it undesirable to market the stock and the company concludes that it is wiser to husband, for working capital, the cash which it had intended to use in paying stockholders a dividend, and, instead, to pay the dividend in the common stock which it had planned to sell; would not the stock so distributed be a distribution of profits-and hence, when received, be income of the stockholder and taxable as such? If this be conceded, why should it not be equally income of the stockholder, and taxable as such, if the common stock created by capitalizing profits, had been originally created for the express purpose of being distributed [252 U.S. 189, 229] as a dividend to the stockholder who afterwards received it?

Second. It has been said that a dividend payable in bonds or preferred stock created for the purpose of distributing profits may be income and taxable as such, but that the case is different where the distribution is in common stock created for that purpose. Various reasons are assigned for making this distinction. One is that the proportion of the stockholder's ownership to the aggregate number of the shares of the company is not changed by the distribution. But that is equally true where the dividend is paid in its bonds or in its preferred stock. Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved. Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder after receipt of the stock dividend has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property, for instance, bonds, scrip or preferred stock of the company. The payment from profits of a large cash dividend, and even a small one, customarily lowers the then market value of stock because the undivided property represented by each share has been correspondingly reduced. The argument which appears to be most strongly urged for the stockholders is, that when a stock dividend is made, no portion of the assets of the company is thereby segregated for the stockholder. But does the issue of new bonds or of preferred stock created for use as a dividend result in any segregation of assets for the stockholder? In each case he receives a piece of paper which entitles him to certain rights in the undivided property. Clearly segregation of assets in a physical sense is not an essential of income. The year's gains of a partner is taxable as income, although there, likewise, no [252 U.S. 189, 230] segregation of his share in the gains from that of his partners is had.

The objection that there has been no segregation is presented also in another form. It is argued that until there is a segregation, the stockholder cannot know whether he has really received gains; since the gains may be invested in plant or merchandise or other property and perhaps be later lost. But is not this equally true of the share of a partner in the year's profits of the firm or, indeed, of the profits of the individual who is engaged in business alone? And is it not true, also, when dividends are paid in cash? The gains of a business, whether conducted by an individual, by a firm or by a corporation, are ordinarily reinvested in large part. Many a cash dividend honestly declared as a distribution of profits, proves later to have been paid out of capital, because errors in forecast prevent correct ascertainment of values. Until a business adventure has been completely liquidated, it can never be determined with certainty whether there have been profits unless the returns at least exceeded the capital originally

invested. Business men, dealing with the problem practically, fix necessarily periods and rules for determining whether there have been net profits-that is, income or gains. They protect themselves from being seriously misled by adopting a system of depreciation charges and reserves. Then, they act upon their own determination, whether profits have been made. Congress in legislating has wisely adopted their practices as its own rules of action.

Third. The Government urges that it would have been within the power of Congress to have taxed as income of the stockholder his pro rata share of undistributed profits earned, even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. See The Collector v. Hubbard, 12 Wall. 1. The undivided share of a partner in the year's undistributed profits of his firm [252 U.S. 189, 231] is taxable as income of the partner, although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. Linn Timber Co. v. United States, 236 U.S. 574 , 35 Sup. Ct. 440. See Morawetz on Corporations (2d Ed.) 227- 231; Cook on Corporations (7th Ed.) 663, 664. The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporations. 5 No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. In other words to render the stockholder taxable there must be both earnings made and a dividend paid. Neither earnings without dividend-nor a dividend without earnings-subjects the [252 U.S. 189, 232] stockholder to taxation under the Revenue Act of 1916.

Fourth. The equivalency of all dividends representing profits, whether paid of all dividends in stock, is so complete that serious question of the taxability of stock dividends would probably never have been made, if Congress had undertaken to tax only those dividends which represented profits earned during the year in which the dividend was paid or in the year preceding. But this court, construing liberally, not only the constitutional grant of power, but also the revenue act of 1913, held that Congress might tax, and had taxed, to the stockholder dividends received during the year, although earned by the company long before; and even prior to the adoption of the Sixteenth Amendment. Lynch v. Hornby, 247 U.S. 339 , 38 Sup. Ct. 543.6 That rule, if indiscriminatingly applied to all stock dividends representing profits earned, might, in view of corporate practice, have worked considerable hardship, and have raised serious questions. Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to 'surplus' account-distinguishing between such permanent 'surplus' and the 'undivided profits' account. Other corporations, without this formality, had assumed that the annual accumulating balances carried as undistributed profits were to be treated as capital permanently invested in the business. And still others, without definite assumption of any kind, had [252 U.S. 189, 233] so used undivided profits for capital purposes. To have made the revenue law apply retroactively so as to reach such accumulated profits, if and whenever it should be deemed desirable to capitalize them legally by the issue of additional stock distributed as a dividend to stockholders, would have worked great injustice. Congress endeavored in the Revenue Act of 1916 to guard against any serious hardship which might otherwise have arisen from making taxable stock dividends representing accumulated profits. It did not limit the taxability to stock dividends representing profits earned within the tax year or

in the year preceding; but it did limit taxability to such dividends representing profits earned since March 1, 1913. Thereby stockholders were given notice that their share also in undistributed profits accumulating thereafter was at some time to be taxed as income. And Congress sought by section 3 (Comp. St. 1918, Comp. St. Ann. Supp. 1919, 6336c) to discourage the postponement of distribution for the illegitimate purpose of evading liability to surtaxes.

Fifth. The decision of this court, that earnings made before the adoption of the Sixteenth Amendment, but paid out in cash dividend after its adoption, were taxable as income of the stockholder, involved a very liberal construction of the amendment. To hold now that earnings both made and paid out after the adoption of the Sixteenth Amendment cannot be taxed as income of the stockholder, if paid in the form of a stock dividend, involves an exceedingly narrow construction of it. As said by Mr. Chief Justice Marshall in Brown v. Maryland, 12 Wheat. 419, 446 (6 L. Ed. 678):

> 'To construe the power so as to impair its efficacy, would tend to defeat an object, in the attainment of which the American public took, and justly took, that strong interest which arose from a full conviction of its necessity.'

No decision heretofore rendered by this court requires us to hold that Congress, in providing for the taxation of [252 U.S. 189, 234] stock dividends, exceeded the power conferred upon it by the Sixteenth Amendment. The two cases mainly relied upon to show that this was beyond the power of Congress are Towne v. Eisner, 245 U.S. 418 , 38 Sup. Ct. 158 L. R. A. 1918D, 254, which involved a question not of constitutional power but of statutory construction, and Gibbons v. Mahon, 136 U.S. 549 , 10 Sup. Ct. 1057, which involved a question arising between life tenant and remainderman. So far as concerns Towne v. Eisner we have only to bear in mind what was there said (245 U.S. 425 , 38 Sup. Ct. 159, L. R. A. 1918D, 254): 'But it is not necessarily true that income means the same thing in the Constitution and the [an] act.' 7 Gibbons v. Mahon is even less an authority for a narrow construction of the power to tax incomes conferred by the Sixteenth Amendment. In that case the court was required to determine how, in the administration of an estate in the District of Columbia, a stock dividend, representing profits, received after the decedent's death, should be disposed of as between life tenant and remainderman. The question was in essence: What shall the intention of the testator be presumed to have been? On this question there was great diversity of opinion and practice in the courts of English-speaking countries. Three well-defined rules were then competing for acceptance; two of these involves an arbitrary rule of distribution, the third equitable apportionment. See Cook on Corporations (7th Ed.) 552-558.

1. The so-called English rule, declared in 1799, by Brander v. Brander, 4 Ves. Jr. 800, that a dividend representing [252 U.S. 189, 235] profits, whether in cash, stock or other property, belongs to the life tenant if it was a regular or ordinary dividend, and belongs to the remainderman if it was an extraordinary dividend.

2. The so-called Massachusetts rule, declared in 1868 by Minot v. Paine, 99 Mass. 101, 96 Am. Dec. 705, that a dividend representing profits, whether regular, ordinary or extrordinary, if in cash belongs to the life tenant, and if in stock belongs to the remainderman.

3. The so-called Pennsylvania rule declared in 1857 by Earp's Appeal, 28 Pa. 368, that where a stock dividend is paid, the court shall inquire into the circumstances under which the fund had been earned and accumulated out of which the dividend, whether a regular, an ordinary or an extraordinary one, was paid. If it finds that the stock dividend was paid out of profits earned since the decedent's death, the stock dividend belongs to the life tenant; if the court finds that the stock dividend was paid from capital or from profits earned before the decedent's death, the stock dividend belongs to the remainderman.

This court adopted in Gibbons v. Mahon as the rule of administration for the District of Columbia the so-called Massachusetts rule, the opinion being delivered in 1890 by Mr. Justice Gray. Since then the same question has come up for decision in many of the states. The so-called Massachusetts rule, although approved by this court, has found favor in only a few states. The so-called Pennsylvania rule, on the other hand, has been adopted since by so many of the states (including New York and California), that it has come to be known as the 'American rule.' Whether, in view of these facts and the practical results of the operation of the two rules as shown by the experience of the 30 years which have elapsed since the decision in Gibbons v. Mahon, it might be desirable for this court to reconsider the question there decided, as [252 U.S. 189, 236] some other courts have done (see 29 Harvard Law Review, 551), we have no occasion to consider in this case. For, as this court there pointed out (136 U.S. 560 , 1059 [34 L. Ed. 525]), the question involved was one 'between the owners of successive interests in particular shares,' and not, as in Bailey v. Railroad Co., 22 Wall. 604, a question 'between the corporation and the government, and [which] depended upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings.'

We have, however, not merely argument; we have examples which should convince us that 'there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital.' Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, L. R. A. 1917F. 806. The Supreme Judical Court of Massachusetts has steadfastly adhered, despite ever-renewed protest, to the rule that every stock dividend is, as between life tenant and remainderman, capital and not income. But in construing the Massachusetts Income Tax Amendment, which is substantially identical with the federal amendment, that court held that the Legislature was thereby empowered to levy an income tax upon stock dividends representing profits. The courts of England have, with some relaxation, adhered to their rule that every extraordinary dividend is, as between life tenant and remainderman, to be deemed capital. But in 1913 the Judicial Committee of the Privy Council held that a stock dividend representing accumulated profits was taxable like an ordinary cash dividend, Swan Brewery Company, Limited v. The King, L. R. 1914 A. C. 231. In dismissing the appeal these words of the Chief Justice of the Supreme Court of Western Australia were quoted (page 236) which show that the facts involved were identical with those in the case at bar:

> 'Had the company distributed the œ101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new SHARES, THE DUTY ON THE œ101,450 [252 U.S. 189, 237] WOULD CLEARLY HAVE BEEN PAYable. is not this virtually the effect of what was actually done? I think it is.'

Sixth. If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends they will pay these taxes not upon their income but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed. 8 In terse, comprehensive language befitting the Constitution, they empowered Congress 'to lay and collect taxes on incomes from whatever source derived.' They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded, not only by the plain people, but by investors and financiers, and by most of the courts of the country, is shown, beyond peradventure, by their acts and by their utterances. It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing [252 U.S. 189, 238] profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. And, as this court has so often said, the high prerogative of declaring an

act of Congress invalid, should never be exercised except in a clear case. 9

> 'It is but a decent respect due to the wisdom, the integrity and the patriotism of the legislative body, by which any law is passed, to presume in favor of its validity, until its violation of the Constitution is proved beyond all reasonable doubt.' Ogden v. Saunders, 12 Wheat. 213, 269.

Mr. Justice CLARKE concurs in this opinion.

Footnotes

[Footnote 1] Title I.-Income Tax.

Part I.-On Individuals.

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived, ... also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: Provided, that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, ... out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, ... which stock dividend shall be considered income, to the amount of its cash value.

[Footnote 2] Moody's p. 1544; Commercial and Financial Chronicle, vol. 94, p. 831; vol. 98, pp. 1005, 1076.

[Footnote 3] Moody's, p. 1548; Commercial and Financial Chronicle, vol. 94, p. 771; vol. 96, p. 1428; vol. 97, p. 1434; vol. 98, p. 1541.

[Footnote 4] Moody's, p. 1547; Commercial and Financial Chronicle, vol. 97, pp. 1589, 1827, 1903; vol. 98, pp. 76, 457; vol. 103, p. 2348. Poor's Manual of Industrials (1918), p. 2240, in giving the 'comparative income account' of the company, describes the 1914 dividend as 'stock dividend paid (200 per cent.)-$2,000,000,' and describes the 1917 dividend as $3,000,000 special cash dividend.'

[Footnote 5] See Some Judicial Myths, by Francis M. Burdick, 22 Harvard Law Review, 393, 394-396; The Firm as a Legal Person, by William Hamilton Cowles, 57 Cent. L. J., 343, 348; The Separate Estates of Non-Bankrupt Partners, by J. D. Brannan, 20 Harvard Law Review, 589-592. Compare Harvard Law Review, vol. 7, p. 426; vol. 14, p. 222; vol. 17, p. 194.

[Footnote 6] The hardship supposed to have resulted from such a decision has been removed in the Revenue Act of 1916 as amended, by providing in section 31b (Comp. St. 1918, Comp. St. Ann. Supp. 1919, 6336z) that such cash dividends shall thereafter be exempt from taxation, if before they are made all earnings made since February 28, 1913, shall have been distributed. Act Oct. 3, 1917, c. 63, 1211, 40 Stat. 338, Act Feb. 24, 1919, c. 18, 201(b), 40 Stat. 1059 (Comp. St. Ann. Supp. 1919, 6336 1/8b).

[Footnote 7] Compare Rugg, C. J., in Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, 910 (L. R. A. 1917F, 806): 'However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the forty- fourth amendment.'

[Footnote 8] Compare Rugg, C. J., Tax Commissioner v. Putnam, 227 Mass. 522, 524, 116 N. E. 904, 910 (L. R. A. 1917F, 806): 'It is a grant from the sovereign people and not the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to such a charter of government ought to be construed in the same spirit and according to the same rules as the original. It is to be interpreted as the Constitution of a state and not as a statute or an ordinary piece of legislation. Its words must be given a construction adapted to carry into effect its purpose.'

[Footnote 9] 'It is our duty, when required in the regular course of judicial proceedings, to declare an act of Congress void if not within the legislative power of the United States; but this declaration should never be made except in a clear case. Every possible presumption is in favor of the validity of a statute, and this continues until the contrary is shown beyond a rational doubt. One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule.' The 'Sinking Fund Cases, 99 U.S. 700 , 718 (1878). See also Legal Tender Cases, 12 Wall. 457, 531 (1870); Trade Mark Cases, 100 U.S. 82 , 96 (1879). See American Doctrine of Constitutional Law by James B. Thayer, 7 Harvard Law Review, 129, 142.

> 'With the exception of the extraordinary decree rendered in the Dred Scott Case, ... all of the acts or the portions of the acts of Congress invalidated by the courts before 1868 related to the organization of courts. Denying the power of Congress to make notes legal tender seems to be the first departure from this rule.' Haines, American Doctrine of Judicial Supremacy, p. 288. The first legal tender decision was overruled in part two years later (1870), Legal Tender Cases, 12 Wall. 457; and again in 1883, Legal Tender Case, 110 U.S. 421 , 4 Sup. Ct. 122.

U.S. Constitution: Sixteenth Amendment

Sixteenth Amendment - Income Tax

Amendment Text | Annotations

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.

Annotations

- **Income Tax**
- **History and Purpose of the Amendment**
- **Income Subject to Taxation**
  - Corporate Dividends: When Taxable
  - Corporate Earnings: When Taxable
  - Gains: When Taxable
  - Income from Illicit Transactions
  - Deductions and Exemptions
  - Diminution of Loss

'); } //

U.S. Constitution: Sixteenth Amendment

Sixteenth Amendment - Income Tax

Amendment Text | Annotations

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.

Annotations

- Income Tax
- History and Purpose of the Amendment
- Income Subject to Taxation
  - Corporate Dividends: When Taxable
  - Corporate Earnings: When Taxable
  - Gains: When Taxable
  - Income from Illicit Transactions
  - Deductions and Exemptions
  - Diminution of Loss

U.S. Supreme Court

STRATTON'S INDEPENDENCE, LTD. v. HOWBERT, 231 U.S. 399 (1913)

231 U.S. 399

STRATTON'S INDEPENDENCE, Limited,
v.
F. W. HOWBERT, Collector of Internal Revenue in and for the District of Colorado.
No. 457.

Argued October 21, 1913.
Decided December 1, 1913.

[231 U.S. 399, 400] Messrs. William V. Hodges, A. A. Hoehling, Jr., and John R. Van Derlip for Stratton's Independence.

[231 U.S. 399, 404] Assistant Attorney General Graham for Howbert, Collector.

[231 U.S. 399, 406] Messrs. Charles S. Thomas, W. H. Bryant, George L. Nye, William P. Malburn, William Story, William Story, Jr., and William D. Guthrie as amici curiae.

Mr. Justice Pitney delivered the opinion of the court:

This action was brought in the district court of the United States by Stratton's Independence, Limited, a British corporation carrying on mining operations in the state of Colorado upon mining lands owned by itself, to recover certain moneys paid under protest for taxes assessed and levied for the years 1909 and 1910 under the provisions of the corporation tax act, being 38 of the act of August 5, 1909 (36 Stat. at L. 11, 112, chap. 6, U. S. Comp. Stat. Supp. 1911, pp. 741, 946). The case was tried upon an agreed statement of facts, from which it appears, as to the year 1909, that the company extracted from its lands

during the year certain ores bearing gold and other precious metals, which were sold by it for sums largely in excess of the cost of mining, extracting, and marketing the same; that the gross sales amounted to $284,682.85, the cost of extracting, mining, and marketing amounted to $190,939.42, and 'the value of said ores so extracted in the year 1909, when in place in said mine and before extraction thereof, was $93,743.43.' With respect to the operations of the company for the year 1910, the agreed facts were practically the same, except as to dates and amounts. It does not appear that the so-called 'value of the ore in place,' or any other sum, was actually charged off upon the books of the company as depreciation. Upon this state of facts each party moved the court for a directed verdict, at the same time presenting for consideration certain questions of law, and among them the following:

> '1. Is the value of the ore in place that was extracted [231 U.S. 399, 407] from the mining property of the plaintiff during the years in question properly allowable as depreciation in estimating the net income of the plaintiff subject to taxation under the act of Congress of August 5, 1909 (36 Stat. at L. chap. 6, p. 11, U. S. Comp. Stat. Supp. 1911, p. 741)?
>
> '2. Is the right to such credit affected by the fact that the plaintiff does not carry such items on its books in a depreciation account?'

The court directed a verdict in favor of the plaintiff with respect to certain amounts that were undisputed and concerning which no question is now raised; but directed a verdict in favor of the defendant with respect to so much of the taxes paid as represented the value in place of the ore that was extracted during the years in question, overruling the contention that such value was properly allowable as depreciation in estimating the net income of the plaintiff. To this ruling proper exceptions were taken. The resulting judgment having been removed by writ of error to the circuit court of appeals, that court certifies that the following questions of law are presented to it, the decision of which is indispensable to a determination of the cause, and upon which it therefore desires the instruction of this court:

> 'I. Does 38 of the act of Congress entitled, 'An Act to Provide Revenue, Equalize Duties, and Encourage the Industries of the United States, and for Other Purposes,' approved August 5, 1909 (36 Stat. at L. p. 11, chap. 6, U. S. Comp. Stat. Supp. 1911, p. 741), apply to mining corporations?
>
> 'II. Are the proceeds of ores mined by a corporation from its own premises income within the meaning of the aforementioned act of Congress?
>
> 'III. If the proceeds from ore sales are to be treated as income, is such a corporation entitled to deduct the value of such ore in place and before it is mined as depreciation within the meaning of 38 of said act of Congress?' [231 U.S. 399, 408] The provisions of 38 are set forth in the margin.1

The principal grounds upon which it is contended that the questions ought to receive answers favorable to the company are expressed in various forms; viz., that mining corporations are sui generis, because the [231 U.S. 399, 409] natural enjoyment of mining lands necessarily results in the waste of the estate; that the true value thereof is impossible of accurate determination, and hence mining corporations are not included in general classifications of corporations as such classifications are employed in other legislation; that the provisions of 38 do not fit

___ sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property;

(second) all losses actually sustained within the year and not compensated by insurance, or otherwise including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts, and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association, or trust company, all interest actually paid by it within the year on deposits; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any state or territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein; (fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; provided, that in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, such net income shall be ascertained by deducting from the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia, (first) all the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States and its territories, Alaska, and the District of Columbia, including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within in the year in business conducted by it within the [231 U.S. 399, 410] the conditions of a mining corporation; that such corporations are not in truth engaged in 'carrying on business' within the meaning of the act; that the application of the act to them results in a tax upon the capital, while as applied to other corporations it does not result in such a tax, the result being an inequality of operation that is

___ United States or its territories, Alaska, or the District of Columbia, not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts, and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia bears to the gross amount of its income derived from all sources within and without the United States; (fourth) the sums paid by it within the year for taxes imposed under the authority of the United States or of any state of territory thereof; (fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, and insurance companies, subject to the tax hereby imposed. In the case of assessment insurance companies the actual deposit of sums with state or territorial officers, pursuant to law, as additions to guaranty or reserve funds, shall be treated as being payments required by law to reserve funds.

Third. There shall be deducted from the amount of the net income of each of such corporations, joint stock companies or associations, or insurance companies, ascertained as provided in the foregoing paragraphs of this section, the sum of five thousand dollars, and said tax shall be computed upon the remainder of said net income of such corporation, joint stock company or association, or insurance company for the year ending December 31, 1909, and for each calendar year thereafter; and on or before the first day of March, 1910, and the first day of March in each year thereafter, a true and accurate return under oath or affirmation of its president, vice president, or other principal officer, and its treasurer or assistant treasurer, shall be made by each of the corporations, joint stock companies or associations, and insurance companies, subject [231 U.S. 399, 411] inherently unjust; that the proceeds of

mining operations do not represent values created by or incident to the business activities of such a corporation, and therefore cannot be a bona fide measure of a tax leveled at such corporate business activities; that the proceeds of mining

___ to the tax imposed by this section, to the collector of internal revenue for the district in which such corporation, joint stock company or association, or insurance company, has its principal place of business, or, in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, in the place where its principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth, (first) the total amount of the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year; (second) the total amount of the bonded and other indebtedness of such corporation, joint stock company or association, or insurance company, at the close of the year; (third) the gross amount of the income of such corporation, joint stock company or association, or insurance company, received during such year from all sources, and if organized under the laws of a foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its territories. Alaska, and the District of Columbia; also the amount received by such corporation, joint stock company or association, or insurance company, within the year by way of dividends upon stock of other corporations, joint stock companies or associations or insurance companies, subject to the tax imposed by this section; (fourth) the total amount of all the ordinary and necessary expenses actually paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint stock company or association, or insurance company, within the year, stating separately all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property, and, if organized under the laws of a foreign country, the amount so paid in the maintenance and operation of its business within the United States and its territories, Alaska, and the District of Columbia; (fifth) the total amount of all losses actually sustained during the year, and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than [231 U.S. 399, 412] operations result from a conversion of the capital represented by real estate into capital represented by cash, and are in no true sense income; and that to measure the tax by the excess of receipts for one marketed over the cost of mining, extracting, and marketing the same, is

___ dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; and in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year, in business conducted by it within the United States or its territories, Alaska, and the District of Columbia, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve fund; (sixth) the amount of interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association, or trust company, stating separately all interest paid by it within the year on deposits; or in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States; (seventh) the amount paid by it within the year for taxes imposed under the

authority of the United States or any state or territory thereof, and separately the amount so paid by it for taxes imposed by the government of any foreign country as a condition to carrying on business therein; (eighth) the net income of such corporation, joint stock company or association, or insurance company, after making the deductions in this section authorized. All such returns shall, as received, be transmitted forthwith by the collector to the Commissioner of Internal Revenue. [231 U.S. 399, 413] equivalent to a direct tax upon the property, and hence unconstitutional. Next, assuming the proceeds of ore are to be treated as income within the meaning of the act, it is yet insisted that such proceeds result solely from the depletion of capital, and are pari passu; and hence that a mining the provisions of the act.

We do not think it necessary to follow the argument through all its refinements. The pith of it is that mining corporations engaged solely in mining upon their own premises have but one kind of assets, and that in the ordinary use of them the enjoyment of the assets and the wasting thereof are in direct proportion, and proceed pari passu; and hence that a mining corporation is not engaged in business, properly speaking, but is merely occupied in converting its capital assets from one form into another, and that a tax upon the doing of such a business, where the tax is measured by the value of the property owned by the corporation, would be in excess of the constitutional limitations that existed at the time of the passage of the act of 1909, as laid down in Pollock v. Farmers' Loan & T. Co. 157 U.S. 429 , 39 L. ed. 759, 15 Sup. Ct. Rep. 673, s. c., 158 U.S. 601 , 39 L. ed. 1108, 15 Sup. Ct. Rep. 912.

The peculiar character of mining property is sufficiently obvious. Prior to development it may present to the naked eye a mere tract of land with barren surface, and of no practical value except for what may be found beneath. Then follow excavation, discovery, development, extraction of ores, resulting eventually, if the process be thorough, in the complete exhaustion of the mineral contents so far as they are worth removing. Theoretically, and according to the argument, the entire value of the mine, as ultimately developed, existed from the beginning. Practically, however, and from the commercial standpoint, the value-that is, the exchangeable or market value-depends upon different considerations. Beginning from little, when the existence, character, and extent of [231 U.S. 399, 414] the ore deposits are problematical, it may increase steadily or rapidly so long as discovery and development outrun depletion, and the wiping out of the value by the practical exhaustion of the mine may be deferred for a long term of years. While not ignoring the importance of such considerations, we do not think they afford the sole test for determining the legislative intent.

As has been repeatedly remarked, the corporation tax act of 1909 was not intended to be and is not, in any proper sense, an income tax law. This court had decided in the Pollock Case that the income tax law of 1894 amounted in effect to a direct tax upon property, and was invalid because not apportioned according to populations, as prescribed by the Constitution. The act of 1909 avoided this difficulty by imposing not an income tax, but an excise tax upon the conduct of business in a corporate capacity, measuring, however, the amount of tax by the income of the corporation, with certain qualifications prescribed by the act itself. Flint v. Stone Tracy Co. 220 U.S. 107 , 55 L. ed. 389, 31 Sup. Ct. Rep. 342, Ann. Cas. 1912 B, 1312; McCoach v. Minehill & S. H. R. Co. 228 U.S. 295 , 57 L. ed. 842, 33 Sup. Ct. Rep. 419; United States v. Whitridge (decided at this term, 231 U.S. 144 , 58 L. ed. --, 34 Sup. Ct. Rep. 24.

For this and other obvious reasons we are little aided by a discussion of theoretical distinctions between capital and income. Such refinements can hardly be deemed to have entered into the legislative purpose. Of course, if it were demonstrable that to read the act according to its letter would render it unconstitutional, or glaringly unequal, or palpably unjust, a reasonable ground would exist for construing it according to its spirit rather than its letter. But in our opinion the act is not fairly open to this criticism. It is not correct, from either the theoretical or the practical standpoint, to say that a mining

corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. The sale outright of a mining property might be fairly described as a mere conversion of the capital from land [231 U.S. 399, 415] into money. But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process. And, however the operation shall be described, the transaction is indubitably 'business' within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for 'income' may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor. As to the alleged inequality of operation between mining corporations and others, it is of course true that the revenues derived from the working of mines result to some extent in the exhaustion of the capital. But the same is true of the earnings of the human brain and hand when unaided by capital, yet such earnings are commonly dealt with in legislation as income. So it may be said of many manufacturing corporations that are clearly subject to the act of 1909, especially of those that have to do with the production of patented articles; although it may be foretold from the beginning that the manufacture will be profitable only for a limited time, at the end of which the capital value of the plant must be subject to material depletion, the annual gains of such corporations are certainly to be taken as income for the purpose of measuring the amount of the tax.

It seems to us that the first two questions certified must be answered in the affirmative principally for two reasons. First, because mining corporations are within the general description of 38, which comprises 'every corporation, joint stock company, or association organized for profit, and having a capital stock represented by shares , . . . and engaged in business in any state or territory of the United [231 U.S. 399, 416] States;' and, secondly, because the act specific those classes of corporations that are to be exempt from its operation, and mining corporations are not among them. Those exempted are labor, agricultural, or horticultural organizations, fraternal beneficiary societies, orders or associations operating under the lodge system, domestic building and loan associations, corporations and associations organized and operated for religious, charitable, or educational purposes, etc. Moreover, the section imposes 'a special excise tax with respect to the carrying on or doing business by such corporation,' etc. That mining companies are doing business, within the fair intent and meaning of this clause, seems to us entirely plain, for reasons already given. The conduct of such business results in profit, for it cannot be seriously contended that the ores are not worth more at the mine mouth than they were worth in the ground, plus the cost of mining. Corporations engaged in such business share in the benefits of the Federal government, and ought as reasonably to contribute to the support of that government as corporations that conduct other kinds of profitable business.

As to what should be deemed 'income' within the meaning of 38, it of course need not be such an income as would have been taxable as such, for at that time (the 16th Amendment not having been as yet ratified) income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned. Evidently Congress adopted the income as the measure of the tax to be imposed with respect to the doing of business in corporate form because it desired that the excise should be imposed, approximately at least, with regard to the amount of benefit presumably derived by such corporations from the current operations of the government. In Flint v. Stone Tracy Co. 220 U.S. 107, 165 , 55 S. L. ed. 107, 419, 31 Sup. Ct. Rep. 342, Ann. Cas. 1912 B. 1312, it was held that Congress, in exercising the right to tax a legitimate subject of taxation as a franchise [231 U.S. 399, 417] or privilege, was not debarred by the Constitution from measuring the taxation by the total income, although derived in part from property which, considered by itself, was not taxable. It was reasonable that Congress should fix upon gross income, without distinction as to source, as a convenient and sufficiently accurate index of the importance of the business transacted. And from this point of view, it makes little difference that the income may arise from a business that theoretically or practically involves a wasting of capital.

Moreover, Congress evidently intended to adopt a measure of the tax that should be easy of ascertainment and simply and readily applied in practice. The act prescribed that the tax should be 'equivalent to one per centum upon the entire net income over and obove $5,000 received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations,' etc., or, with respect to foreign corporations, 'upon the amount of net income over and obove $5,000, received by it from business transacted and capital invested within the United States,' etc. And the net income was to be ascertained by taking, first, the 'gross amount of the income of such corporation . . . received within the year from all sources,' or, in the case of foreign corporations, 'from business transacted and capital invested within,' etc., and deducting therefrom losses sustained, interest paid, etc. And the return was to be made under oath by the president and treasurer, or other officers having like duties, indicating in the clearest manner that it was to set forth data that with proper accounting would appear upon the books of the corporation. We have no difficulty, therefore, in concluding that the proceeds of ores mined by a corporation from its own premises are to be taken as a part of the gross income of such corporation. Congress no doubt contemplated that such corporations, amongst others, were doing business [231 U.S. 399, 418] with a wasting capital, and for such wastage they made due provision in declaring that from the gross income there should be deducted (inter alia) 'all losses actually sustained within the year,' including 'a reasonable allowance for depreciation of property, if any,' etc.

This brings us to the third question, which is whether such a mining corporation is entitled to deduct the value of ore in place and before it is mined, as depreciation within the meaning of 38. This question, however, is to be read in the light of the issue that is presented to the circuit court of appeals for determination, as recited in the certificate. From that certificate it appears that the case was submitted to the trial court and a verdict directed upon an agreed statement of facts, and in that statement the gross proceeds of the sale of the ores during the year were diminished by the moneys expended in extracting, mining, and marketing the ores, and the precise difference was taken to be the value of the ores when in place in the mine.

That we do not misconstrue the certificate, and that, on the contrary, the parties advisedly adopted this definition of 'value of the ore in place,' is apparent not only from the form of the agreed statement of facts, but from the arguments presented here in behalf of the plaintiff. The contention is that if the proceeds of ore sales are to be treated as income, the value of the ore in place and before it is mined is to be deducted as depreciation, and that such value is to be arrived at by the process indicated. Briefs submitted in behalf of amici curioe have suggested other modes for determining depreciation; but plaintiff stands squarely upon the ground indicated by the certificate, as the following excerpts from the brief will show: 'Assuming, then, that the proceeds of ore are to be treated as income within the meaning of the act, we submit that such proceeds result solely from depletion of capital, and are therefore deductible as depreciation under the [231 U.S. 399, 419] provisions [of the act] set out above. . . . And we contend that if a part of the capital assets are removed and sold, the property, as it originally stood, is actually depreciated in value to the exact extent of such removal. As an actual matter of experience, the original cost of the property must, from its very nature, be highly speculative. The values in the property are invisible and impossible of determination. They may be worth many times the cost, or they may be worth nothing. . . . The value of the ore in sight does represent a part of the capital, but there is no warrant for limiting it to this amount, nor is there any warrant for limiting the value of ore bodies thereafter discovered in any case to a standard fixed before their discovery, and therefore, of necessity, purely conjectural. . . . The true capital of a mining corporation is the true value of the minerals within the limits of its properties, irrespective of developed ore bodies or those known to exist at any one moment. Investigation or development may demonstrate the existence of values theretofore unknown, but this results in no addition to the actual capital. It remains the same as it was before. . . .' And again: 'With every dollar's worth removed, the land from which it is taken contains that much less of value; the corporation owns precisely that much less real property than it possessed before; for every

dollar of cash received it relinquishes an equivalent amount of ore in place, and makes no gain or profit by the exchange.'

Reading these extracts in connection with what is contended respecting the first and second questions,-to the effect that mining corporations are not 'doing business,' but are merely converting their capital assets from one form into another,-it is clear that a definition of the 'value of the ore in place' has been intentionally adopted that excludes all allowance of profit upon the process of mining, and attributes the entire profit upon the mining [231 U.S. 399, 420] operations to the mine itself. In short, the parties propose to estimate the depreciation of a mining property attributable to the extraction of ores according to principles that would be applicable if the ores had been removed by a trespasser.

It is at the same time obvious that any method of stating the account that excludes all element of gain from the process of mining must, through one process or another, exempt mining companies from liability to tax under the act of 1909 with respect to their mining operations. And so, an affirmative answer to the third question as propounded would be the same in effect as an affirmative answer to the first or the second. For it is a matter of little or no moment whether it is to be said (a) that mining corporations are not 'engaged in business' at all, or (b) that they are engaged in business, but the proceeds of ore mined are not income, or (c) that such proceeds are income, but that there must be allowed as depreciation all that part of the proceeds which remains after paying the bare outlays of the business. In either case mining corporations would be exempt from the tax.

In our opinion, there are at least two insuperable obstacles in the way of returning an affirmative answer to the third question as certified.

In the first place, it is fallacious to say that, whatever may have been the original cost of a mining property or the cost of developing it, if in fact it afterwards yield ores aggregating many times its original cost or market value, this result merely proves and at the same time measures the intrinsic value that existed from the beginning. We are here seeking the correct interpretation and construction of an act of legislation that was, at least, designed to furnish a practicable mode of raising revenue for the support of the government, and to do this in part by imposing annual taxes upon corporations organized for profit, and by measuring the amount of the contribution [231 U.S. 399, 421] to be required from each corporation according to its annual income. The act deals with corporations engaged in actual business transactions, and presumably conducted according to ordinary business principles. It was of course contemplated that the income might be derived from the employment of property in business, and that this property might become more or less exhausted in the process; and because of this, a reasonable allowance was to be made for depreciation of it, if any. But plainly, we think, the valuation of the property and the amount of the depreciation were to be determined not upon the basis of latent and occult intrinsic values, but upon considerations that affect market value and have their influence upon men of affairs charged with the management of the business and accounting of corporations that are organized for profit and are engaged in business for purposes of profit.

And, secondly, assuming the depletion of the mineral stock is an element to be considered in determining the reasonable depreciation that is to be treated as a loss in the ascertainment of the net income of a mining company under the act, we deem it quite inadmissible to estimate such depletion as if it had been done by a trespasser, to whom all profit is denied.

With respect to the proper measure of damages where ore has been unlawfully mined by one person upon the land of another, there is much conflict of authority. Different modes of determining the damages have been resorted to, dependent sometimes upon the form of the action, whether trespass or trover; sometimes upon whether the case arose at law or in equity; and often upon whether the trespass

was willful or inadvertent. See E. E. Bolles Woodenware Co. v. United States, 106 U.S. 432 , 27 L. ed. 230, 1 Sup. Ct. Rep. 398, and cases cited; Benson Min. & Smelting Co. v. Alta Min. & Smelting Co. 145 U.S. 428, 434 , 36 S. L. ed. 762, 765, 12 Sup. Ct. Rep. 877, 17 Mor. Min. Rep. 488; Pine River Logging & Improv. Co. v. United States, 186 U.S. 279, 293 , 46 S. L. ed. 1164, 1171, 22 Sup. Ct. Rep. 920; United States v. St. Anthony R. Co. 192 U.S. 524, 542 , 48 S. L. ed. 548, 555, 24 Sup. Ct. Rep. 333; Martin v. Porter (1839) 5 Mees. & W. [231 U.S. 399, 422] 352, 2 Horn. & H. 70, 17 Eng. Rul. Cas. 841, 10 Mor. Min. Rep. 75; Jegon v. Vivian (1871) L. R. 6 Ch. 742, 760, 40 L. J. Ch. N. S. 389, 19 Week. Rep. 365, 17 Eng. Rul. Cas. 843, 8 Mor. Min. Rep. 628; Livingstone v. Rawyards Coal Co. (1880) L. R. 5 App. Cas. 25, 34, 42 L. T. N. S. 334, 28 Week. Rep. 357, 44 J. P. 392, 10 Mor. Min. Rep. 291; Coal Creek Min. & Mfg. Co. v. Moses, 15 Lea, 300, 54 Am. Rep. 415, 15 Mor. Min. Rep. 544; Winchester v. Craig, 33 Mich. 205. See also English and American Notes to Martin v. Porter, and Jegon v. Vivian, 17 Eng. Rul. Cas. 873, 876, etc. We are not at this time concerned with this vexed question, beyond saying that the rules applicable to trespassers can have only a modified application to the case of a mine owner conducting mining operations upon its own lands, where the question is,-What is the income derived from the business?-and the incidental question,-What is the reasonable depreciation, if any, of the mining property?

What has been said necessitates a negative answer to the third question as certified. And we shall not go further into the question of depreciation. The case comes here under 239, Judicial Code [36 Stat. at L. 1157, chap. 231, U. S. Comp. Stat. Supp. 1911, p. 228] (derived from 6 of the Evarts act, 26 Stat. at L. 828, chap. 517, U. S. Comp. Stat. 1901, p. 549). It is established that in the exercise of this jurisdiction this court, unless it see occasion to require the whole record to be sent up for consideration, is to make answer respecting the several propositions of law that are certified, and is not to go into questions of fact, or of mixed law and fact. Our Rule 37 requires that the certificate shall contain a proper statement of the facts upon which the questions of law arise, and we deal with the facts as thus certified, and not otherwise. Graver v. Faurot, 162 U.S. 435, 437 , 40 S. L. ed. 1030, 1031, 16 Sup. Ct. Rep. 799; Cross v. Evans, 167 U.S. 60, 63 , 42 S. L. ed. 77, 78, 17 Sup. Ct. Rep. 733; United States v. Union P. R. Co. 168 U.S. 505, 512 , 42 S. L. ed. 559, 561, 18 Sup. Ct. Rep. 167; Emsheimer v. New Orleans, 186 U.S. 33 , 46 L. ed. 1042, 22 Sup. Ct. Rep. 770; Cincinnati, H. & D. R. Co. v. McKeen, 149 U.S. 259 , 37 L. ed. 725, 13 Sup. Ct. Rep. 840.

It would therefore be improper for us at this time to enter into the question whether the clause, 'a reasonable allowance for depreciation of property, if any,' calls for an allowance on that account in making up the tax, where [231 U.S. 399, 423] no depreciation is charged in practical bookkeeping; or the question whether depreciation, when allowable, may properly be based upon the depletion of the ore supply estimated otherwise than in the mode shown by the agreed statement of facts herein; for to do this would be to attribute a different meaning to the term 'value of the ore in place' than the parties have put upon it, and to instruct the circuit court of appeals respecting a question about which instruction has not been requested, and concerning which it does not even appear that any issue is depending before that court.

The first and second questions certified will be answered in the affirmative; and the third question will be answered in the negative.

Mr. Chief Justice White, Mr. Justice McKenna, and Mr. Justice Holmes dissent with respect to the answer made to the third question.

Footnotes

[Footnote 1] Sec. 38. That every corporation, joint stock company, or association, organized for profit

and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any state or territory of the United States, or under the acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country, and engaged in business in any state or territory of the United States, or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporations, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; or if organized under the laws of any foreign country, upon the amount of net income over and above five thousand dollars received by it from business transacted and capital invested within the United States and its territories, Alaska, and the District of Columbia during such year, exclusive of amounts so received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; provided, however, that nothing in this section contained shall apply to labor, agricultural or horticultural organizations, or to fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations, and dependents of such members, nor to domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members, nor to any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.

Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint Stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, all interest actually paid by it within the year on deposits; (fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country as a condition to carrying on business therein; (fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; provided, that in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, such net income shall be ascertained by deducting from the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, (first) all the ordinary and necessary expenses actually paid within the year out of earnings in the maintenance and operation of its business and property within the United States and its Territories, Alaska, and the District of Columbia, including all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year in business conducted by it within the United States or its Territories, Alaska, or the District of Columbia not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other

than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia bears to the gross amount of its income derived from all sources within and without the United States; (fourth) the sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof; (fifth) all amounts received by it within the year as dividends upon stock of other corporations, joint stock companies or associations, and insurance companies, subject to the tax hereby imposed. In the case of assessment insurance companies the actual deposit of sums with state or territorial officers, pursuant to law, as additions to guaranty or reserve funds shall be treated as being paymentsrequired by law to reserve funds.

Third. There shall be deducted from the amount of the net income of each of such corporations, joint stock companies or associations, or insurance companies, ascertained as provided in the foregoing paragraphs of this section, the sum of five thousand dollars, and said tax shall be computed upon the remainder of said net income of such corporation, joint stock company or association, or insurance company, for the year ending December 31, 1909, and for each calendar year thereafter; and on or before the first day of March, 1910, and the first day of March in each year thereafter, a true and accurate return under oath or affirmation of its president, vice-president, or other principal officer, and its treasurer or assistant treasurer, shall be made by each of the corporations, joint stock companies or associations, and insurance companies, subject to the tax imposed by this section, to the collector of internal revenue for the district in which such corporation, joint stock company or association, or insurance company, has its principal place of business, or, in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, in the place where its principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth, (first) the total amount of the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year; (second) the total amount of the bonded and other indebtedness of such corporation, joint stock company or association, or insurance company at the close of the year; (third) the gross amount of the income of such corporation, joint stock company or association, or insurance company, received during such year from all sources, and if organized under the laws of a foreign country the gross amount of its income received within the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia; also the amount received by such corporation, joint stock company or association, or insurance company, within the year by way of dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed by this section; (fourth) the total amount of all the ordinary and necessary expenses actually paid out of earnings in the maintenance and operation of the business and properties of such corporation, joint stock company or association, or insurance company, within the year, stating separately all charges such as rentals or franchise payments required to be made as a condition to the continued use or possession of property, and if organized under the laws of a foreign country the amount so paid in the maintenance and operation of its business within the United States and its Territories, Alaska, and the District of Columbia; (fifth) the total amount of all losses actually sustained during the year and not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds; and in the case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, all losses actually sustained by it during the year in business conducted by it within the United States or its Territories, Alaska, and the

District of Columbia, not compensated by insurance or otherwise, stating separately any amounts allowed for depreciation of property, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve fund; (sixth) the amount of interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, stating separately all interest paid by it within the year on deposits; or in case of a corporation, joint stock company or association, or insurance company, organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia, bears to the gross amount of its income derived from all sources within and without the United States; (seventh) the amount paid by it within the year for taxes imposed under the authority of the United States or any State or Territory thereof, and separately the amount so paid by it for taxes imposed by the government of any foreign country as a condition to carrying on business therein; (eighth) the net income of such corporation, joint stock company or association, or insurance company, after making the deductions in this section authorized. All such returns shall as received be transmitted forthwith by the collector to the Commissioner of Internal Revenue.

The principal grounds upon which it is contended that the questions ought to receive answers favorable to the company are expressed in various forms, viz., that mining corporations are sui generis, because the natural enjoyment of mining lands necessarily results in the waste of the estate; that the true value thereof is impossible of accurate determination, and hence mining corporations are not included in general classifications of corporations as such classifications are employed in other legislation; that the provisions of § 38 do not fit the conditions of a mining corporation; that such corporations are not in truth engaged in "carrying on business" within the meaning of the Act; that the application of the Act to them results in a tax upon the capital, while as applied to other corporations it does not result in such a tax, the result being an inequality of operation that is inherently unjust; that the proceeds of mining operations do not represent values created by or incident to the business activities of such a corporation, and therefore cannot be a bona fide measure of a tax leveled at such corporate business activities; that the proceeds of mining operations result from a conversion of the capital represented by real estate into capital represented by cash, and are in no true sense income; and that to measure the tax by the excess of receipts for ore marketed over the cost of mining, extracting and marketing the same, is equivalent to a direct tax upon the property, and hence unconstitutional. Next, assuming the proceeds of ore are to be treated as income within the meaning of the Act, it is yet insisted that such proceeds result solely from the depletion of capital, and are therefore deductible as depreciation under the provisions of the Act.

We do not think it necessary to follow the argument through all its refinements. The pith of it is that mining corporations engaged solely in mining upon their own premises have but one kind of assets, and that in the ordinary use of them the enjoyment of the assets and the wasting thereof are in direct proportion, and proceed pari passu; and hence that a mining corporation is not engaged in business, properly speaking, but is merely occupied in converting its capital assets from one form into another, and that a tax upon the doing of such a business, where the tax is measured by the value of the property owned by the corporation, would be in excess of the constitutional limitations that existed at the time of the passage of the act of 1909, as laid down in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429; S.C., 158 U.S. 601.

The peculiar character of mining property is sufficiently obvious. Prior to development it may present to the naked eye a mere tract of land with barren surface, and of no practical value except for what may be found beneath. Then follow excavation, discovery, development, extraction of ores, resulting eventually, if the process be thorough, in the complete exhaustion of the mineral contents so far as they are worth removing. Theoretically, and according to the argument, the entire value of the mine, as ultimately developed, existed from the beginning. Practically, however, and from the commercial standpoint, the value -- that is, the exchangeable or market value -- depends upon different considerations. Beginning from little, when the existence, character and extent of the ore deposits are problematical, it may increase steadily or rapidly so long as discovery and development outrun depletion, and the wiping out of the value by the practical exhaustion of the mine may be deferred for a long term of years. While not ignoring the importance of such considerations, we do not think they afford the sole test for determining the legislative intent.

As has been repeatedly remarked, the Corporation Tax Act of 1909 was not intended to be and is not in any proper sense an income tax law. This court had decided in the Pollock Case that the income tax law of 1894 amounted in effect to a direct tax upon property, and was invalid because not apportioned according to population as prescribed by the Constitution. The act of 1909 avoided this difficulty by imposing not an income tax, but an excise tax upon the conduct of business in a corporate capacity, measuring, however, the amount of tax by the income of the corporation, with certain qualifications prescribed by the Act itself. Flint v. Stone-Tracy Co., 220 U.S. 107; McCoach v. Minehill Co., 228 U.S. 295; United States v. Whitridge, (decided at this term, ante, p. 144).

For this and other obvious reasons we are little aided by a discussion of theoretical distinctions between capital and income. Such refinements can hardly be deemed to have entered into the legislative purpose. Of course, if it were demonstrable that to read the Act according to its letter would render it unconstitutional, or glaringly unequal, or palpably unjust, a reasonable ground would exist for construing it according to its spirit rather than its letter. But in our opinion the Act is not fairly open to this criticism. It is not correct, from either the theoretical or the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money. But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process. And, however the operation shall be described, the transaction in indubitably "business" within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for "income" may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor. As to the alleged inequality of operation between mining corporations and others, it is of course true that the revenues derived from the working of mines result to some extent in the exhaustion of the capital. But the same is true of the earnings of the human brain and hand when unaided by capital, yet such earnings are commonly dealt with in legislation as income. So it may be said of many manufacturing corporations that are clearly subject to the act of 1909, especially of those that have to do with the production of patented articles; although it may be foretold from the beginning that the manufacture will be profitable only for a limited time, at the end of which the capital value of the plant must be subject to material depletion, the annual gains of such corporations are certainly to be taken as income for the purpose of measuring the amount of the tax.

It seems to us that the first two questions certified must be answered in the affirmative principally for two reasons. First, because mining corporations are within the general description of § 38, which comprises "every corporation, joint stock company or association organized for profit and having a capital stock represented by shares, . . . and engaged in business in any state or territory of the United

States;" and, secondly, because the Act specifies those classes of corporations that are to be exempt from its operation, and mining corporations are not among them. Those exempted are labor, agricultural or horticultural organizations, fraternal beneficiary societies, orders or associations operating under the lodge system, domestic building and loan associations, corporations and associations organized and operated for religious, charitable, or educational purposes, etc. Moreover, the section imposes "a special excise tax with respect to the carrying on or doing business by such corporation," etc. That mining companies are doing business, within the fair intent and meaning of this clause, seems to us entirely plain, for reasons already given. The conduct of such business results in profit, for it cannot be seriously contended that the ores are not worth more at the mine mouth than they were worth in the ground, plus the cost of mining. Corporations engaged in such business share in the benefits of the Federal Government, and ought as reasonably to contribute to the support of that Government as corporations that conduct other kinds of profitable business.

As to what should be deemed "income" within the meaning of § 38, it of course need not be such an income as would have been taxable as such, for at that time (the Sixteenth Amendment not having been as yet ratified), income was not taxable as such by Congress without apportionment according to population, and this tax was not so apportioned. Evidently Congress adopted the income as the measure of the tax to be imposed with respect to the doing of business in corporate form because it desired that the excise should be imposed, approximately at least, with regard to the amount of benefit presumably derived by such corporations from the current operations of the Government. In Flint v. Stone-Tracy Co., 220 U.S. 107, 165, it was held that Congress in exercising the right to tax a legitimate subject of taxation as a franchise or privilege, was not debarred by the Constitution from measuring the taxation by the total income, although derived in part from property which, considered by itself, was not taxable. It was reasonable that Congress should fix upon gross income, without distinction as to source, as a convenient and sufficiently accurate index of the importance of the business transacted. And from this point of view, it makes little difference that the income may arise from a business that theoretically or practically involves a wasting of capital.

Moreover, Congress evidently intended to adopt a measure of the tax that should be easy of ascertainment and simply and readily applied in practice. The Act prescribed that the tax should be "equivalent to one per centum upon the entire net income over and above $ 5,000 received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations," etc., or, with respect to foreign corporations, "upon the amount of net income over and above $ 5,000 received by it from business transacted and capital invested within the United States," etc. And the net income was to be ascertained by taking, first, the "gross amount of the income of such corporation . . . received within the year from all sources," or, in the case of foreign corporation, "from business transacted and capital invested within," etc., and deducting therefrom losses sustained, interest paid, etc. And the return was to be made under oath by the president and treasurer, or other officers having like duties, indicating in the clearest manner that it was to set forth data that with proper accounting would appear upon the books of the corporation. We have no difficulty, therefore, in concluding that the proceeds of ores mined by a corporation from its own premises are to be taken as a part of the gross income of such corporation. Congress no doubt contemplated that such corporations, amongst others, were doing business with a wasting capital, and for such wastage they made due provision in declaring that from the gross income there should be deducted (inter alia) "all losses actually sustained within the year," including "a reasonable allowance for depreciation of property, if any," etc. This brings us to the third question, which is whether such a mining corporation is entitled to deduct the value of ore in place and before it is mined, as depreciation within the meaning of § 38. This question, however, is to be read in the light of the issue that is presented to the Circuit Court of Appeals for determination, as recited in the certificate. From that certificate it appears that the case was submitted to the trial court and a verdict directed upon an agreed statement of facts, and in that statement the gross proceeds of the sale of the ores during the year were diminished by the moneys

expended in extracting, mining, and marketing the ores, and the precise difference was taken to be the value of the ores when in place in the mine. That we do not misconstrue the certificate, and that, on the contrary, the parties advisedly adopted this definition of "value of the ore in place," is apparent not only from the form of the agreed statement of facts, but from the arguments presented here in behalf of the plaintiff. The contention is that if the proceeds of ore sales are to be treated as income, the value of the ore in place and before it is mined is to be deducted as depreciation, and that such value is to be arrived at by the process indicated. Briefs submitted in behalf of amici curiae have suggested other modes for determining depreciation; but plaintiff stands squarely upon the ground indicated by the certificate, as the following excerpts from the brief will show: "Assuming, then, that the proceeds of ore are to be treated as income within the meaning of the Act, we submit that such proceeds result solely from depletion of capital, and are therefore deductible as depreciation under the provisions [of the Act] set out above. . . . And we contend that if a part of the capital assets are removed and sold, the property, as it originally stood, is actually depreciated in value to the exact extent of such removal. As an actual matter of experience, the original cost of the property must, from its very nature, be highly speculative. The values in the property are invisible, and impossible of determination. They may be worth many times the cost, or they may be worth nothing. . . . The value of the ore in sight does represent a part of the capital; but there is no warrant for limiting it to this amount, nor is there any warrant for limiting the value of ore bodies thereafter discovered in any case to a standard fixed before their discovery, and therefore, of necessity, purely conjectural. . . . The true capital of a mining corporation is the true value of the minerals within the limits of its properties, irrespective of developed ore bodies or those known to exist at any one moment. Investigation or development may demonstrate the existence of values theretofore unknown, but this results in no addition to the actual capital. It remains the same as it was before. . . ." And again, "With every dollar's worth removed, the land from which it is taken contains that much less of value; the corporation owns precisely that much less real property than it possessed before; for every dollar of cash received it relinquishes an equivalent amount of ore in place, and makes no gain or profit by the exchange."

Reading these extracts in connection with what is contended respecting the first and second questions -- to the effect that mining corporations are not "doing business," but are merely converting their capital assets from one form into another -- it is clear that a definition of the "value of the ore in place" has been intentionally adopted that excludes all allowance of profit upon the process of mining, and attributes the entire profit upon the mining operations to the mine itself. In short, the parties propose to estimate the depreciation of a mining property attributable to the extraction of ores according to principles that would be applicable if the ores had been removed by a trespasser.

It is at the same time obvious that any method of stating the account that excludes all element of gain from the process of mining must, through one process or another, exempt mining companies from liability to tax under the act of 1909 with respect to their mining operations. And so, an affirmative answer to the third question as propounded would be the same in effect as an affirmative answer to the first or the second. For it is a matter of little or no moment whether it is to be said (a) that mining corporations are not "engaged in business" at all, or (b) that they are engaged in business but the proceeds of ore mined are not income, or (c) that such proceeds are income, but that there must be allowed as depreciation all that part of the proceeds which remains after paying the bare outlays of the business. In either case mining corporations would be exempt from the tax.

In our opinion, there are at least two insuperable obstacles in the way of returning an affirmative answer to the third question as certified.

In the first place, it is fallacious to say that, whatever may have been the original cost of a mining property or the cost of developing it, if in fact it afterwards yield ores aggregating many times its

original cost or market value, this result merely proves and at the same time measures the intrinsic value that existed from the beginning. We are here seeking the correct interpretation and construction of an act of legislation that was, at least, designed to furnish a practicable mode of raising revenue for the support of the Government, and to do this in part by imposing annual taxes upon corporations organized for profit and by measuring the amount of the contribution to be required from each corporation according to its annual income. The Act deals with corporations engaged in actual business transactions and presumably conducted according to ordinary business principles. It was of course contemplated that the income might be derived from the employment of property in business, and that this property might become more or less exhausted in the process; and because of this, a reasonable allowance was to be made for depreciation of it, if any. But plainly, we think, the valuation of the property and the amount of the depreciation were to be determined not upon the basis of latent and occult intrinsic values, but upon considerations that affect market value and have their influence upon men of affairs charged with the management of the business and accounting of corporations that are organized for profit and are engaged in business for purposes of profit.

And, secondly, assuming the depletion of the mineral stock is an element to be considered in determining the reasonable depreciation that is to be treated as a loss in the ascertainment of the net income of a mining company under the Act, we deem it quite inadmissible to estimate such depletion as if it had been done by a trespasser, to whom all profit is denied.

With respect to the proper measure of damages where ore has been unlawfully mined by one person upon the land of another, there is much conflict of authority. Different modes of determining the damages have been resorted to, dependent sometimes upon the form of the action, whether trespass or trover; sometimes upon whether the case arose at law or in equity; and often upon whether the trespass was willful or inadvertent. See Wooden-ware Co. v. United States, 106 U.S. 432, and cases cited; Benson Mining Co. v. Alta Mining Co., 145 U.S. 428, 434; Pine River Logging Co. v. United States, 186 U.S. 279, 293; United States v. St. Anthony R. Co., 192 U.S. 524, 542; Martin v. Porter (1839), 5 M. & W. 351, 352; Jegon v. Vivian (1871), L.R. 6 Ch. 742, 760; 40 L.J. Ch. 389; 19 W.R. 365; Livingstone v. Rawyards Coal Co. (1880), 5 App. Cas. 25, 34; 42 L.T., N.S., 334; Coal Creek M. & M. Co. v. Moses, 15 Lea (Tenn.), 300; 54 Am. Rep. 415; Winchester v. Craig, 33 Michigan, 205. See also English and American Notes to Martin v. Porter, and Jegon v. Vivian, 17 Eng. Rul. Cas. 873, 876, etc. We are not at this time concerned with this vexed question, beyond saying that the rules applicable to trespassers can have only a modified application to the case of a mine owner conducting mining operations upon its own lands, where the question is, -- What is the income derived from the business? -- and the incidental question, -- What is the reasonable depreciation, if any, of the mining property?

What has been said necessitates a negative answer to the third question as certified. And we shall not go further into the question of depreciation. The case comes here under § 239, Judicial Code (derived from § 6 of the Evarts Act, March 3, 1891, 26 Stat. 826, 828, c. 517). It is established that in the exercise of this jurisdiction this court, unless it see occasion to require the whole record to be sent up for consideration, is to make answer respecting the several propositions of law that are certified, and is not to go into questions of fact, or of mixed law and fact. Our Rule 37 requires that the certificate shall contain a proper statement of the facts upon which the questions of law arise, and we deal with the facts as thus certified, and not otherwise. Graver v. Faurot, 162 U.S. 435, 437; Cross v. Evans, 167 U.S. 60, 63; United States v. Union Pacific Railway, 168 U.S. 505, 512; Emsheimer v. New Orleans, 186 U.S. 33; Cincinnati, Hamilton Railroad v. McKeen, 149 U.S. 259.

It would therefore be improper for us at this time to enter into the question whether the clause, "a reasonable allowance for depreciation of property, if any" calls for an allowance on that account in making up the tax, where no depreciation is charged in practical bookkeeping; or the question whether

depreciation, when allowable, may properly be based upon the depletion of the ore supply estimated otherwise than in the mode shown by the agreed statement of facts herein; for to do this would be to attribute a different meaning to the term "value of the ore in place" than the parties have put upon it, and to instruct the Circuit Court of Appeals respecting a question about which instruction has not been requested, and concerning which it does not even appear that any issue is depending before that court.

The first and second questions certified will be answered in the affirmative; and the third question will be answered in the negative.

MR. CHIEF JUSTICE WHITE, MR. JUSTICE McKENNA, and MR. JUSTICE HOLMES dissent with respect to the answer made to the third question.

U.S. Supreme Court

DOYLE v. MITCHELL BROS. CO. , 247 U.S. 179 (1918)

247 U.S. 179

DOYLE, Collector of Internal Revenue,
v.
MITCHELL BROS. CO.
No. 492.

Argued March 4, 5, and 6.
Decided May 20, 1918.

[247 U.S. 179, 180] Mr. Solicitor General Davis, of Washington, D. C., for petitioner.

Messrs. Mark Norris and Oscar E. Waer, both of Grand Rapids, Mich., for respondent.

Mr. Justice PITNEY delivered the opinion of the Court.

This was an action to recover from the Collector additional taxes assessed against the respondent under the Corporation Excise Tax Act of August 5, 1909 (chapter 6, 36 Stat. 11, 112, 38), and paid under protest. The District Court gave judgment for the plaintiff, which was affirmed by the Circuit Court of Appeals (225 Fed. 437; 235 Fed. 686, 149 C. C. A. 106, L. R. A. 1917E, 568), and the case comes here on certiorari.

It was submitted at the same time with several other cases decided this day, arising under the same act. [247 U.S. 179, 181] The facts are as follows: Plaintiff is a lumber manufacturing corporation which operates its own mills, manufactures into lumber therein its own stumpage, sells the lumber in the market, and from these sales and sales of various by-products makes its profits, declares its dividends,

and creates its surplus. It sells its stumpage lands, so-called, after the timber is cut and removed. Its sole business is as described; it is not a real estate trading corporation. Plaintiff acquired certain timber lands at its organization in 1903 and paid for them at a valuation approximately equivalent to $20 per acre. Owing to increases in the market price of stumpage the market value of the timber land, on December 31, 1908, had become approximately $40 per acre. 1 The company made no entry upon its books representing this increase, but each year entered as a profit the difference between the original cost of the timber cut and the sums received for the manufactured product, less the cost of manufacture. After the passage of the Excise Tax Act, and preparatory to making a return of income for the year 1909, the company revalued its timber stumpage as of December 31, 1908, at approximately $40 per acre. The good faith and accuracy of this valuation are not in question, but the figures representing it never were entered in the corporate books.

Under the act the company made a return for each of the years 1909, 1910, 1911, and 1912, and in each instance deducted from its gross receipts the market value, as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax. There appears to have been no change in its market value during these years.

The Commissioner of Internal Revenue having al- [247 U.S. 179, 182] lowed a deduction of the cost of the timber in 1903 and refused to allow the difference between that cost and the fair market value of the timber on December 31, 1908, the question is whether this difference (made the basis of the additional taxes) was income for the years in which it was converted into money, within the meaning of the act.

Other items are involved in the case, arising from the sale of certain stump lands, certain by-products, and a parcel of real extate, but they raise no different question from that which arises upon the valuation of the stumpage, and need not be further mentioned.

The act became effective January 1, 1909, and provided for the annual payment by every domestic corporation 'organized for profit and having a capital stock represented by shares' of an excise tax 'equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year,' with exceptions not now material. It declared that such net income should be ascertained by deducting from the gross income received within the year from all sources the expenses paid within the year out of income in the maintenance and operation of business and property, including rentals and the like; losses sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property; interest paid within the year to a limited extent; taxes; and amounts received within the year as dividends upon stock of other corporations subject to the same tax. In the case of a corporation organized under the laws of a foreign country, the net income was to be ascertained by taking into account the gross income received within the year 'from business transacted and capital invested within the United States and any of its territories, Alaska, and the District of Columbia,' with deductions for expenses of maintenance and operation, [247 U.S. 179, 183] business losses, interest, and taxes, all referable to that portion of its business transacted and capital invested within the United States, etc.

An examination of these and other provisions of the act makes it plain that the legislative purpose was not to tax property as such, or the mere conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the gainful returns from their business operations and property from the time the act took effect. As was pointed out in Flint v. Stone Tracy Co., 220 U.S. 107, 145 , 31 S. Sup. Ct. 342, 347 (55 L. Ed. 389, Ann. Cas. 1912B, 1312) the tax was imposed 'not upon the franchises of the corporation irrespective of their use in business, nor upon the proper y of the corporation, but upon the doing of corporate or insurance business and with respect to the carrying on thereof'; an exposition that has been consistently adhered to. McCoach v. Minehill R. R.

Co., 228 U.S. 295, 300 , 33 S. Sup. Ct. 419; United States v. Whitridge, 231 U.S. 144, 147 , 34 S. Sup. Ct. 24; Anderson v. Forty-Two Broadway, 239 U.S. 69, 72 , 36 S. Sup. Ct. 17.

When we come to apply the act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the act, questions of difficulty are encountered. The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.'

Starting from this point, the learned Solicitor General has submitted an elaborate argument in behalf of the [247 U.S. 179, 184] government, based in part upon theoretical definitions of 'capital,' 'income,' 'profits,' etc., and in part upon expressions quoted from our opinions in Flint v. Stone Tracy Co., 220 U.S. 107, 147 , 31 S. Sup. Ct. 342, Ann. Cas. 1912B, 1312, and Anderson v. Forty-Two Broadway, 239 U.S. 69, 72 , 36 S. Sup. Ct. 17, with the object of showing that a conversion of capital into money always produces income, and that for the purposes of the present case the words 'gross income' are equivalent to 'gross receipts'; the insistence being that the entire proceeds of a conversion of capital assets should be treated as gross income, and that by deducting the mere cost of such assets we arrive at net income. The cases referred to throw little light upon the present matter, and the expressions quoted from the opinions were employed by us with reference to questions wholly remote from any that is here presented.

The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter. If the gross receipts upon such a conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes. There is no express provision that even allows a merchant to deduct the cost of the goods that he sells.

Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. [247 U.S. 179, 185] Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in Stratton's Independence v. Howbert, 231 U.S. 399, 415 , 34 S. Sup. Ct. 136: 'Income may be defined as the gain derived from capital, from labor, or from both combined.'

Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

This has been recognized from the beginning by the administrative officers of the government. Shortly after the passage of the act, and before the time (March 1, 1910) for making the first returns of income, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, promulgated Regulations No. 31, under date December 3, 1909, for the guidance of collectors and other subordinate officers in the performance of their duties under the act. These prescribed, with respect to manufacturing companies, that gross income should consist of the difference between the price received for the goods as sold and the cost of such goods as manufactured; cost to be 'ascertained by an addition of a charge to the account of goods as [247 U.S. 179, 186] manufactured during the year of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year.' In the case of mercantile companies, gross income was to be the 'amount ascertained through inventory, or its equivalent, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge to the account of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year.' And as to miscellaneous corporations, gross income was to be 'the gross revenue derived from the operation and management of the business and property of the corporation,' with all income derived from other sources. The matter of income arising from a profitable sale of capital assets was dealt with specifically in such a way as to limit the tax to income arising after the effective date of the act. This was done by adopting the rule that an advance in value arising during a period of years should be so adjusted that only so much as properly was attributable to the time subsequent to January 1, 1909 (December 31, 1908, would have been more precise), should be subjected to the tax. 2 Subsequent treasury regulations, promulgated from time to time (T. D. 1606), March 29, 1910, [247 U.S. 179, 187] paragraphs 40, 71, 76; T. D. 1675, February 14, 1911, paragraphs 37, 55, 75; T. D. 1742, December 15, 1911, paragraphs 43, 62, 86, 91), adhered to the same rule with respect to lands bought prior to January 1, 1909, and sold during a subsequent year, prescribing, however, that the profits, when not otherwise accurately determinable, should be prorated according to the time elapsed before and after the act took effect; and gave to it an application especially pertinent here, one of the regulations reading:

> 'The mere removal of timber by cutting from timber lands, unless the timber is otherwise disposed of through sales or plant operations, is considered simply a change in form of assets. If said timber is disposed of through sales or otherwise, it is to be accounted for in accordance with regulations governing disposition of capital and other assets.'

In our opinion these regulations correctly interpret the act in its application to the facts of the present case. When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and a subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act as in force. Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute.

The plaintiff, in making up its income tax returns for the years 1909, 1910, 1911, and 1912, deducted from its gross receipts the admittedly accurate valuation as of December 31, 1908, of the stumpage cut and converted DURING [247 U.S. 179, 188] THE YEAR COVERED BY THE TAX. THERe having been no change in market values during these years, the deduction did but restore to the capital in money that which had been withdrawn in stumpage cut, leaving the aggregate of capital neither increased nor decreased, and leaving the residue of the gross receipts to represent the gain realized by the conversion, so far as that gain arose while the act was in effect. This was in accordance with the true intent and meaning of the act.

It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact should be deducted from gross receipts in the process of ascertaining gross income, or should be deducted from gross income in the form of a depreciation account in the process of determining net inome. In either case the object is to distinguish capital previously existing from income taxable under the act.

There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act. Von Baumbach v. Sargent Land Co., 242 U.S. 503, 520 , 524 S., 37 Sup. Ct. 201; United States v. Biwabik Mining Co., 247 U.S. 116 , 38 Sup. Ct. 462, 62 L. Ed. --, this day decided; Goldfield Consolidated Mines Co. v. Scott, 247 U.S. 126 , 38 Sup. Ct. 465, 62 L. Ed. --, this day decided.

It should be added that in this case no question is raised as to whether, in apportioning the profits derived from a disposition of capital assets acquired before and converted after the act took effect, the division should be pro rata, according to the time elapsed, or should be based upon an inventory taken as of December 31, 1908. Plaintiffs, in accordance with Treasury Regulations No. 31, T. D. 1578, January 4, 1910, and T. D. 1588, January [247 U.S. 179, 189] 24, 1910, adopted the latter method, and the government makes no contention as to the accuracy of the result thereby reached, under the stipulated facts, if our construction of the act be correct.

Judgment affirmed.

Footnotes

[Footnote 1] The valuations were based upon the quantity of standing timber, at certain prices per thousand feet for the different varieties. The approximate acreage equivalent is employed for convenience.

[Footnote 2] Extract from Treasury Regulations No. 31, issued December 3, 1909.

Sale of Capital Assets.-In ascertaining income derived from the sale of capital assets, if the assets were acquired subsequent to January 1, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1, 1909, and which proportion shall be deducted from or added to the gross income for the year in which the sale was made.

Southern Pacific Co. v. Lowe, 247 U.S. 330, 38 S.Ct. 540 (1918)

Supreme Court of the United States

SOUTHERN PAC. CO.

v.

LOWE, Collector of Internal Revenue.

No. 452.

Argued March 4, 5, and 6, 1918.

Decided June 3, 1918.

Mr. Justice PITNEY delivered the opinion of the Court.

This case presents a question arising under the Federal Income Tax Act of October 3, 1913 (chapter 16, 38 Stat. 114, 166). Suit was brought by plaintiff in error against the collector to recover taxes assessed against it and paid under protest. There ware two causes of action, of which only the second went to trial, it having been stipulated that the trial of the other might be postponed until the final determination of this one. So far as it is presented to us, the suit is an effort to recover a tax imposed upon certain dividends upon stock, in form received by the plaintiff from another corporation in the early part of the year 1914, and alleged by the plaintiff to have been paid out of a surplus accumulated not only prior to the effective date of the act but prior to the adoption of the Sixteenth Amendment to the Constitution of the United States. The district court directed a verdict and judgment in favor of the collector (238 Fed. 847), and the case comes here by direct writ of error under section 238, Judicial Code (Act March 3, 1911, c. 231, 36 Stat. 1157 [Comp. St. 1916, § 1215]), because of the constitutional question. That our jurisdiction was properly invoked is settled by Towne v. Eisner, 245 U. S. 418, 425, 38 Sup. Ct. 158, 62 L. Ed. 372.

The case was submitted at the same time with several other cases arising under the same act and decided this day, viz., Lynch, Collector, v. Turrish, 247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087, Lynch, Collector, v. Hornby, by, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149, and Peabody v. Eisner, Collector, 247 U. S. 347, 38 Sup. Ct. 546, 62 L. Ed. 1152.

The material facts are as follows: Prior to January 1, 1913, and at all times material to the case, plaintiff, a corporation organized under the laws of the state of Kentucky owned all the capital stock of the Central Pacific Railway Company, a corporation of the state of Utah, including the stock registered in the names of the directors. [FN1] This situation existed continuously from the incorporation of the Railway Company in the year 1899. That company is the successor of the Central Pacific Railroad Company and acquired all of its properties, which constitute a part of a large system of railways owned or controlled by the Southern Pacific Company. The latter company, besides being sole stockholder, was in the actual physical possession of the railroads and all other assets of the Railway Company, and in charge of it operations, which were conducted in accordance with the terms of a lease made by the predecessor company to the Southern Pacific and assumed by the Railway Company, the effect of which was that the Southern Pacific should pay to the lessor

company $10,000 per annum for organization expenses, should operate the railroads, branches, and leased lines belonging to the lessor, and account annually for the net earnings, and if these exceeded 6 per cent. on the existing capital stock of the lessor the lessee should retain to itself one- half of the excess; advances by the lessee for account of the lessor were to bear lawful interest, and the lessee was to be entitled at any time and from time to time to refund to itself its advances and interest out of any net earnings which might be in its hands. The provisions of the lease were observed by both corporations for bookkeeping purposes. The Southern Pacific acted as cashier and banker for the entire system; the Central Pacific kept no bank account, its earnings being deposited with the bank account of the Southern Pacific; and if the Central Pacific needed money for additions and betterments or for making up a deficit of current earnings, the necessary funds were advanced by the Southern Pacific. As a result of these operations and of the conversion of certain capital assets of the Central Pacific Company, that company showed upon its books a large surplus accumulated prior to January 1, 1913, principally in the form of a debit against the Southern Pacific, which at the same time, as sole stockholder, was entitled to any and all dividends that might be declared, and being in control of the board of directors was able to and did control the dividend policy. The dividends in question were declared and paid during the first six months of the year 1914 out of this surplus of the Central Pacific accumulated prior to January 1, 1913; but the payment was only constructive, being carried into effect by bookkeeping entries which simply reduced the apparent surplus of the Central Pacific and reduced the apparent indebtedness of the Southern Pacific to the Central Pacific by precisely the amount of the dividends.

The question is whether the dividends received under these circumstances and in this manner by the Southern Pacific Company were taxable as income of that company under the Income Tax Act of 1913. [FN2]

The act provides, in section 2, paragraph A, subdivision 1 (38 Stat. 166), 'that there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year' to every person residing in the United States a tax of 1 per centum per annum, with exceptions not now material. By paragraph G (a), p. 172, it is provided 'that the normal tax hereinbefore imposed upon individuals [1 per cent.] likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation * * * organized in the United States,' with other provisions not now material.

It is provided in paragraph G (b), as to domestic corporations, that such net income shall be ascertained by deducting from the gross amount of the income of the corporation (1) ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals and the like; (2) losses sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any, and in the case of mines a certain allowance for depletion of ores and other natural deposits; (3) interest accrued and paid within the year upon indebtedness of the corporation, within prescribed limits; (4) national and state taxes paid. It will be observed that moneys received as dividends upon the stock of other corporations are not deducted, as they are in computing the income of individuals for the purpose of the normal tax under this act (page 167), and as they were in computing the income of a corporation under the Excise Tax Act of August 5, 1909 (chapter 6, 36 Stat. 11, 113, § 38).

By paragraph G(c), the tax upon corporations is to be computed upon the entire net income accrued within each calendar year, but for the year 1913 only upon the net income accrued from March 1 to December 31, to be ascertained by taking five-sixths of the entire net income for the calendar year.

The purpose to refrain from taxing income that accrued prior to March 1, 1913, and to exclude from

consideration in making the computation any income that accrued in a preceding calendar year, is made plain by the provision last referred to; indeed, the Sixteenth Amendment, under which for the first time Congress was authorized to tax income from property without apportioning the tax among the states according to population, received the approval of the requisite number of states only in February, 1913. Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 581, 15 Sup. Ct. 673, 39 L. Ed. 759; Id., 158 U. S. 601, 637, 15 Sup. Ct. 912, 39 L. Ed. 1108; Brushaber v. Union Pacific R. R., 240 U. S. 1, 16, 36 Sup. Ct. 236, 60 L. Ed. 493, Ann. Cas. 1917B, 713, L. R. A. 1917D, 414.

We must reject in this case, as we have rejected in cases arising under the Corporation Excise Tax Act of 1909 (Doyle, Collector, v. Mitchell Brothers Co., 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054, and Hays, Collector, v. Gauley Mountain Coal Co., 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061, decided May 20, 1918), the broad contention submitted in behalf of the government that all receipts--everything that comes in--are income within the proper definition of the term 'gross income,' and that the entire proceeds of a conversion of capital assets, in whatever form and under whatever circumstances accomplished, should be treated as gross income. Certainly the term 'income' has no broader meaning in the 1913 act than in that of 1909 (see Stratton's Independence v. Howbert, 231 U. S. 399, 416, 417, 34 Sup. Ct. 136, 58 L. Ed. 285), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer.

That the dividends in question were paid out of a surplus that accrued to the Central Pacific prior to January 1, 1913, is undisputed; and we deem it to be equally clear that this surplus accrued to the Southern Pacific Company prior to that date, in every substantial sense pertinent to the present inquiry, and hence underwent nothing more than a change of form when the dividends were declared.

We do not rest this upon the view that for the purposes of the act of 1913 stockholders in the ordinary case have the same interest in the accumulated earnings of the company before as after the declaration of dividends. The act is quite different in this respect from the Income Tax Act of June 30, 1864 (chapter 173, 13 Stat. 223, 281, 282), under which this court held, in Collector v. Hubbard, 12 Wall. 1, 16, 20 L. Ed. 272, that an individual was taxable upon his proportion of the earnings of the corporation although not declared as dividends. That decision was based upon the very special language of a clause of section 117 of the act (13 Stat. 282) that 'the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.' The act of 1913 contains no similar language, but on the contrary deals with dividends as a particular item of income, leaving them free from the normal tax imposed upon individuals, subjecting them to the graduated surtaxes only when received as dividends (38 Stat. 167, paragraph B), and subjecting the interest of an individual shareholder in the undivided gains and profits of his corporation to these taxes only in case the company is formed or fraudulently availed of for the purpose of preventing the imposition of such tax by permitting gains and profits to accumulate instead of being divided or distributed. [FN3] Our view of the effect of this act upon dividends received by the ordinary stockholder after it took effect but paid out of a surplus that accrued to the corporation before that event, is set forth in Lynch, Collector, v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149, decided this day.

We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the 1st day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of

income accruing after that date, while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent and subject in all things to its proper direction and control. And, besides, the funds represented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. The fact that the books were kept in accordance with the provisions of the lease, so that these funds appeared upon the accounts as an indebtedness of the lessee to the lessor, cannot be controlling, in view of the practical identity between lessor and lessee. Aside from the interests of creditors and the public--and there is nothing to suggest that the interests of either were concerned in the disposition of the surplus of the Central Pacific--the Southern Pacific was entitled to dispose of the matter as it saw fit. There is no question of there being a surplus to warrant the dividends at the time they were made, hence any speculation as to what might have happened in case of financial reverses that did not occur is beside the mark.

It is true that in ordinary cases the mere accumulation of an adequate surplus does not entitle a stockholder to dividends until the directors in their discretion declare them. New York, etc., Railroad v. Nickals, 119 U. S. 296, 306, 7 Sup. Ct. 209, 30 L. Ed. 363; Gibbons v. Mahon, 136 U. S. 549, 558, 10 Sup. Ct. 1057, 34 L. Ed. 525. And see Humphreys v. McKissock, 140 U. S. 304, 312, 11 Sup. Ct. 779, 35 L. Ed. 473. But this is not the ordinary case. In fact the discretion of the directors was affirmatively exercised by declaring dividends out of the surplus that was accumulated prior to January 1, 1913; it does not appear that any other fair exercise of discretion was open; and the complete ownership and right of control of the Southern Pacific at all times material makes it a matter of indifference whether the vote was at one time or another. Under the circumstances, the entire matter of the declaration and payment of the dividends was a paper transaction to bring the books into accord with the acknowledged rights of the Southern Pacific; and so far as the dividends represented the surplus of the Central Pacific that accumulated prior to January 1, 1913, they were not taxable as income of the Southern Pacific within the true intent and meaning of the act of 1913.

The case turns upon its very peculiar facts, and is distinguishable from others in which the question of the identity of a controlling stockholder with his corporation has been raised. Pullman Car. Co. v. Missouri Pacific Co., 115 U. S. 587, 596, 6 Sup. Ct. 194, 29 L. Ed. 499; Peterson v. Chicago, Rock Island & Pacific Ry., 205 U. S. 364, 391, 27 Sup. Ct. 513, 51 L. Ed. 841.

Judgment reversed, and the cause remanded for further proceedings in conformity with this opinion.

Mr. Justice CLARKE dissents.

Footnotes:

FN1 There was another question, concerning a dividend paid by the Reward Oil Company, whose stock likewise was owned by the Southern Pacific Company, but the contention of plaintiff in error respecting this item has been abandoned.

FN2 In addition, a question was made in the District Court as to a special dividend declared by the Central Pacific out of the proceeds of sale of certain land on Long Island, taken in satisfaction of a debt and sold in December, 1913. As to this, however, no argument is submitted by plaintiff in error, the facts are not clear, and we pass it without consideration.

FN3 'For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed or for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation * * * is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business.' 38 Stat. 166, 167.

Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1919)

Supreme Court of the United States

EISNER, Internal Revenue Collector,

v.

MACOMBER.

No. 318.

Decided March 8, 1920.

In Error to the District Court of the United States for the Southern District of New York.

Action by Myrtle H. Macomber against Mark Eisner, as Collector of Internal Revenue for the Third District of the State of New York. Judgment for plaintiff on demurrer, and defendant brings error. Affirmed.

Mr. Justice PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916 (39 Stat. 756 et seq., c. 463 [Comp. St. § 6336a et seq.]), which, in our opinion (notwithstanding a contention of the government that will be noticed), plainly evinces the purpose of Congress to tax stock dividends as income. [FN1]

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent. of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 per cent., or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a

tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated article 1, § 2, cl. 3, and article 1, § 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. A general demurrer to the complaint was overruled upon the authority of Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

The case was argued at the last term, and reargued at the present term, both orally and by additional briefs.

We are constrained to hold that the judgment of the District Court must be affirmed: First, because the question at issue is controlled by Towne v. Eisner, supra; secondly, because a re-examination of the question with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.

In Towne v. Eisner, the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913 (38 Stat. 114, 166, c. 16), which provided (section B, p. 167) that net income should include 'dividends,' and also 'gains or profits and income derived from any source whatever.' Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the District Court sustained a demurrer to the complaint. 242 Fed. 702. The court treated the construction of the act as inseparable from the interpretation of the Sixteenth Amendment; and, having referred to Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 Sup. Ct. 912, 39 L. Ed. 1108, and quoted the Amendment, proceeded very properly to say (242 Fed. 704):

> 'It is manifest that the stock dividend in question cannot be reached by the Income Tax Act and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income.'

It declined, however, to accede to the contention that in Gibbons v. Mahon, 136 U. S. 549, 10 Sup. Ct. 1057, 34 L. Ed. 525, 'stock dividends' had received a definition sufficiently clear to be controlling, treated the language of this court in that case as obiter dictum in respect of the matter then before it (242 Fed. 706), and examined the question as res nova, with the result stated. When the case came here, after overruling a motion to dismiss made by the government upon the ground that the only question involved was the construction of the statute and not its constitutionality, we dealt upon the merits with the question of construction only, but disposed of it upon consideration of the essential nature of a stock dividend disregarding the fact that the one in question was based upon surplus earnings that accrued before the Sixteenth Amendment took effect. Not only so, but we rejected the reasoning of the District Court, saying (245 U. S. 426, 38 Sup. Ct. 159, 62 L. Ed. 372, L. R. A. 1918D, 254):

> 'Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not

> diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons v. Mahon, 136 U. S. 549, 559, 560 [10 Sup. Ct. 1057, 34 L. Ed. 525]. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County v. United States, 169 U. S. 255, 261 [18 Sup. Ct. 361, 42 L. Ed. 737]. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. * * * What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.'

This language aptly answered not only the reasoning of the District Court but the argument of the Solicitor General in this court, which discussed the essential nature of a stock dividend. And if, for the reasons thus expressed, such a dividend is not to be regarded as 'income' or 'dividends' within the meaning of the act of 1913, we are unable to see how it can be brought within the meaning of 'incomes' in the Sixteenth Amendment; it being very clear that Congress intended in that act to exert its power to the extent permitted by the amendment. In Towne v. Eisner it was not contended that any construction of the statute could make it narrower than the constitutional grant; rather the contrary.

The fact that the dividend was charged against profits earned before the act of 1913 took effect, even before the amendment was adopted, was neither relied upon nor alluded to in our consideration of the merits in that case. Not only so, but had we considered that a stock dividend constituted income in any true sense, it would have been held taxable under the act of 1913 notwithstanding it was based upon profits earned before the amendment. We ruled at the same term, in Lynch v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149, that a cash dividend extraordinary in amount, and in Peabody v. Eisner, 247 U. S. 347, 38 Sup. Ct. 546, 62 L. Ed. 1152, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the amendment. In the former case, concerning 'corporate profits that accumulated before the act took effect,' we declared (247 U. S. 343, 344, 38 Sup. Ct. 543, 545):

> 'Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. * * * Congress was at liberty under the amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing.'

In Peabody v. Eisner, 247 U. S. 349, 350, 38 Sup. Ct. 546, 547 (62 L. Ed. 1152), we observed that the decision of the District Court in Towne v. Eisner had been reversed 'only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest,' and we distinguished the Peabody Case from the Towne Case upon the ground that 'the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution in specie of a portion of the assets of the Union Pacific.'

Therefore Towne v. Eisner cannot be regarded as turning upon the point that the surplus accrued to the company before the act took effect and before adoption of the amendment. And what we have quoted from the opinion in that case cannot be regarded as obiter dictum, it having furnished the entire basis for the conclusion reached. We adhere to the view then expressed, and might rest the present case there, not because that case in terms decided the constitutional question, for it did not, but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.

Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. 757 [Comp. St. § 6336b]) that a 'stock dividend shall be considered income, to the amount of its cash value,' we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.

The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 Sup. Ct. 912, 39 L. Ed. 1108, under the Act of August 27, 1894 (28 Stat. 509, 553, c. 349, § 27), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by article 1, § 2, cl. 3, and section 9, cl. 4, of the original Constitution.

Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished:

> '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.'

As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. Brushaber v. Union Pacific R. R. Co., 240 U. S. 1, 17-19, 36 Sup. Ct. 236, 60 L. Ed. 493, Ann. Cas. 1917B, 713, L. R. A. 1917D, 414; Stanton v. Baltic Mining Co., 240 U. S. 103, 112 et seq., 36 Sup. Ct. 278, 60 L. Ed. 546; Peck & Co. v. Lowe, 247 U. S. 165, 172, 173, 38 Sup. Ct. 432, 62 L. Ed. 1049.

A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it

may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton's Independence v. Howbert, 231 U. S. 399, 415, 34 Sup. Ct. 136, 140 [58 L. Ed. 285]; Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185, 38 Sup. Ct. 467, 469 [62 L. Ed. 1054]), 'Income may be defined as 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, to which it was applied in the Doyle Case, 247 U. S. 183, 185, 38 Sup. Ct. 467, 469 (62 L. Ed. 1054).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. '*Derived--from--capital';* 'the *gain--derived--from--capital*,' etc. Here we have the essential matter: *not* a gain *accruing to* capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*'--that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal--*that* is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment--'incomes, *from* whatever *source derived*'--the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or par value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the

interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company he can do so only by disposing of his stock.

For bookeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a 'capital stock account.' If profits have been made and not divided they create additional bookkeeping liabilities under the head of 'profit and loss,' 'undivided profits,' 'surplus account,' or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar--by declaring a 'stock dividend.' This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed 'dividend'; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the 'liability' acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing 'capital stock' at the expense of 'surplus'; it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

Being concerned only with the true character and effect of such a dividend when lawfully made, we lay aside the question whether in a particular case a stock dividend may be authorized by the local law governing the corporation, or whether the capitalization of profits may be the result of correct judgment and proper business policy on the part of its management, and a due regard for the interests of the stockholders. And we are considering the taxability of bona fide stock dividends only.

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six- fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power--that 'right preservative of rights' in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

Throughout the argument of the government, in a variety of forms, runs the fundamental error already mentioned--a failure to appraise correctly the force of the term 'income' as used in the Sixteenth Amendment, or at least to give practical effect to it. Thus the government contends that the tax 'is levied on income derived

from corporate earnings,' when in truth the stockholder has 'derived' nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings 'are received by the stockholder,' whereas he has received none; that the profits are 'distributed by means of a stock dividend,' although a stock dividend distributes no profits; that under the act of 1916 'the tax is on the stockholder's share in corporate earnings,' when in truth a stockholder has no such share, and receives none in a stock dividend; that 'the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains,' whereas there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent--a capital interest in the entire concerns of the corporation.

We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners, when they are not such, treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend--even one paid in money or property--can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends extent to which the gains accumulated by the extend to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values--a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.

The government's reliance upon the supposed analogy between a dividend of the corporation's own shares and one made by distributing shares owned by it in the stock of another company, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not, and for no citation of authority except Peabody v. Eisner, 247 U. S. 347, 349, 350, 38 Sup. Ct. 546, 62 L. Ed. 1152.

Two recent decisions, proceeding from courts of high jurisdiction, are cited in support of the position of the government.

Swan Brewery Co., Ltd. v. Rex, [1914] A. C. 231, arose under the Dividend Duties Act of Western Australia, which provided that 'dividend' should include 'every dividend, profit, advantage, or gain intended to be paid or credited to or distributed among any members or directors of any company,' except, etc. There was a stock dividend, the new shares being allotted among the shareholders pro rata; and the question was whether this was a distribution of a dividend within the meaning of the act. The Judicial Committee of the Privy Council sustained the dividend duty upon the ground that, although 'in ordinary language the new shares would not be called a dividend, nor would the allotment of them be a distribution of a dividend,' yet, within the meaning of the act, such new shares were an 'advantage' to the recipients. There being no constitutional restriction upon the action of the lawmaking body, the case presented merely a question of statutory construction, and manifestly the decision is not a precedent for the guidance of this court when acting under a duty to test an act of Congress by the limitations of a written Constitution having superior force.

In Tax Commissioner v. Putnam (1917) 227 Mass. 522, 116 N. E. 904, L. R. A. 1917F, 806, it was held that the Forty-Fourth amendment to the Constitution of Massachusetts, which conferred upon the Legislature full power to tax incomes, 'must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income' (227 Mass. 526, 531, 116 N. E. 904, 907 [L. R. A. 1917F, 806]), and that under it a stock dividend was taxable as income; the court saying (227 Mass. 535, 116 N. E. 911, L. R. A. 1917F, 806):

> 'In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares.'

We cannot accept this reasoning. Evidently, in order to give a sufficiently broad sweep to the new taxing provision, it was deemed necessary to take the symbol for the substance, accumulation for distribution, capital accretion for its opposite; while a case where money is paid into the hand of the stockholder with an option to buy new shares with it, followed by acceptance of the option, was regarded as identical in substance with a case where the stockholder receives no money and has no option. The Massachusetts court was not under an obligation, like the one which binds us, of applying a constitutional amendment in the light of other constitutional provisions that stand in the way of extending it by construction.

Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, supra, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that by the true construction of the act of 1916 the tax is imposed, not upon the stock dividend, but rather upon the stockholder's share of the undivided profits

previously accumulated by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question, and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

The government relies upon Collector v. Hubbard (1870) 12 Wall. 1, (20 L. Ed. 272), which arose under section 117 of the Act of June 30, 1864 (13 Stat. 223, 282, c. 173), providing that----

> 'The gains and profits of all companies, whether incorporated or partnership, other than the companies specified in that section, shall be included in estimating the annual gains, profits, or income of any person, entitled to the same, whether divided or otherwise.'

The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (12 Wall. 18, 20 L. Ed. 272):

> 'Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees.'

In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 627, 628, 637, 15 Sup. Ct. 912, 39 L. Ed. 1108. Conceding Collector v. Hubbard was inconsistent with the doctrine of that case, because it sustained a direct tax upon property not apportioned among the states, the government nevertheless insists that the sixteenth Amendment removed this obstacle, so that now the Hubbard Case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

Thus, from every point of view we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue

Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, § 2, cl. 3, and article 1, § 9, cl. 4, of the Constitution, and to this extent is invalid, notwithstanding the Sixteenth Amendment.

Judgment affirmed.

Mr. Justice HOLMES, dissenting.

I think that Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254, was right in its reasoning and result and that on sound principles the stock dividend was not income. But it was clearly intimated in that case that the construction of the statute then before the Court might be different from that of the Constitution. 245 U. S. 425, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918D, 254. I think that the word 'incomes' in the Sixteenth Amendment should be read in 'a sense most obvious to the common understanding at the time of its adoption.' Bishop v. State, 149 Ind. 223, 230, 48 N. E. 1038, 1040, 39 L. R. A. 278, 63 Am. St. Rep. 270; State v. Butler, 70 Fla. 102, 133, 69 South. 771. For it was for public adoption that it was proposed. McCulloch v. Maryland, 4 Wheat. 316, 407, 4 L. Ed. 579. The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. See Tax Commissioner v. Putnam, 227 Mass. 522, 532, 533, 116 N. E. 904, L. R. A. 1917F, 806.

Mr. Justice DAY concurs in this opinion.

Mr. Justice BRANDEIS delivered the following [dissenting] opinion:

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. .arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and, at the same time, for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market

conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend. How these two methods have been employed may be illustrated by the action in this respect (as reported in Moody's Manual, 1918 Industrial, and the Commercial and Financial Chronicle) of some of the Standard Oil companies, since the disintegration pursuant to the decision of this court in 1911. Standard Oil Co. v. United States, 221 U. S. 1, 31 Sup. Ct. 502, 55 L. Ed. 619, 34 L. R. A. (N. S.) 834, Ann. Cas. 1912D, 734.

(a) Standard Oil Co. (of Indiana), an Indiana corporation. It had on December 31, 1911, $1,000,000 capital stock (all common), and a large surplus. On May 15, 1912, it increased its capital stock to $30,000,000, and paid a simple stock dividend of 2,900 per cent. in stock. [FN2]

(b) Standard Oil Co. (of Nebraska), a Nebraska corporation. It had on December 31, 1911, $600,000 capital stock (all common), and a substantial surplus. On April 15, 1912, it paid a simple stock dividend of 33 1/3 per cent., increasing the outstanding capital to $800,000. During the calendar year 1912 it paid cash dividends aggregating 20 per cent., but it earned considerably more, and had at the close of the year again a substantial surplus. On June 20, 1913, it declared a further stock dividend of 25 per cent., thus increasing the capital to $1,000,000. [FN3]

(c) The Standard Oil Co. (of Kentucky), a Kentucky corporation. It had on December 31, 1913, $1,000,000 capital stock (all common) and $3,701,710 surplus. Of this surplus $902,457 had been earned during the calendar year 1913, the net profits of that year having been $1,002,457 and the dividends paid only $100,000 (10 per cent.). On December 22, 1913, a cash dividend of $200 per share was declared payable on February 14, 1914, to stockholders of record January 31, 1914, and these stockholders were offered the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor. The outstanding stock was thus increased to $3,000,000. During the calendar years 1914, 1915, and 1916, quarterly dividends were paid on this stock at an annual rate of between 15 per cent. and 20 per cent., but the company's surplus increased by $2,347,614, so that on December 31, 1916, it had a large surplus over its $3,000,000 capital stock. On December 15, 1916, the company issued a circular to the stockholders, saying:

> 'The company's business for this year has shown a very good increase in volume and a proportionate increase in profits, and it is estimated that by January 1, 1917, the company will have a surplus of over $4,000,000. The board feels justified in stating that if the proposition to increase the capital stock is acted on favorably, it will be proper in the near future to declare a cash dividend of 100 per cent. and to allow the stockholders the privilege pro rata according to their holdings, to purchase the new stock at par, the plan being to allow the stockholders, if they desire, to use their cash dividend to pay for the new stock.'

The increase of stock was voted. The company then paid a cash dividend of 100 per cent., payable May 1, 1917, again offering to such stockholders the right to subscribe for an equal amount of new stock at par and to apply the cash dividend in payment therefor.

Moody's Manual, describing the transaction with exactness, says first that the stock was increased from $3,000,000 to $6,000,000, 'a cash dividend of 100 per cent., payable May 1, 1917, being exchanged for one share of new stock, the equivalent of a 100 per cent. stock dividend.' But later in the report giving, as customary in the Manual the dividend record of the company, the Manual says: 'A stock dividend of 200 per cent. was paid February 14, 1914, and one of 100 per cent. on May 1, 1197.' And in reporting specifically the income account of the company for a series of years ending December 31, covering net profits, dividends

paid and surplus for the year, it gives, as the aggregate of dividends for the year 1917, $660,000 (which was the aggregate paid on the quarterly cash dividend--5 per cent. January and April; 6 per cent. July and October), and adds in a note: 'In addition a stock dividend of 100 per cent. was paid during the year.' [FN4] The Wall Street Journal of May 2, 1917, p. 2, quotes the 1917 'high' price for Standard Oil of Kentucky as '375 ex stock dividend.'

It thus appears that among financiers and investors the distribution of the stock, by whichever method effected, is called a stock dividend; that the two methods by which accumulated profits are legally retained for corporate purposes and at the same time distributed as dividends are recognized by them to be equivalents; and that the financial results to the corporation and to the stockholders of the two methods are substantially the same--unless a difference results from the application of the federal Income Tax Law.

Mrs. Macomber, a citizen and resident of New York, was, in the year 1916, a stockholder in the Standard Oil Company (of California), a corporation organized under the laws of California and having its principal place of business in that state. During that year she received from the company a stock dividend representing profits earned since March 1, 1913. The dividend was paid by direct issue of the stock to her according to the simple method described above, pursued also by the Indiana and Nebraska companies. In 1917 she was taxed under the federal law on the stock dividend so received at its par value of $100 a share, as income received during the year 1916. Such a stock dividend is income, as distinguished from capital, both under the law of New York and under the law of California, because in both states every dividend representing profits is deemed to be income, whether paid in cash or in stock. It had been so held in New York, where the question arose as between life tenant and remainderman, Lowry v. Farmers' Loan & Trust Co., 172 N. Y. 137, 64 N. E. 796; Matter of Osborne, 209 N. Y. 450, 103 N. E. 723, 823, 50 L. R. A. (N. S.) 510, Ann.Cas. 1915A, 298; and also, where the question arose in matters of taxation, People v. Glynn, 130 App. Div. 332, 114 N. Y. Supp. 460; Id. 198 N. Y. 605, 92 N. E. 1097. It has been so held in California, where the question appears to have arisen only in controversies between life tenant and remainderman. Estate of Duffill, 183 Pac. 337.

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky; that is, issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased--the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income.

The Sixteenth Amendment, proclaimed February 25, 1913, declares:

> '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.'

The Revenue Act of September 8, 1916, c. 463, § 2a, 39 Stat. 756, 757, provided:

> 'That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, * * * which stock dividend shall be considered income, to the amount of its cash value.'

Hitherto powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power the substance of the transaction, not its form has been regarded. Martin v. Hunter, 1 Wheat, 304, 326, 4 L. Ed. 97; McCulloch v. Maryland, 4 Wheat. 316, 407, 415, 4 L. Ed. 579; Brown v. Maryland, 12 Wheat. 419, 446, 6 L. Ed. 678; Craig v. Missouri, 4 Pet. 410, 433, 7 L. Ed. 903; Jarrolt v. Moberly, 103 U. S. 580, 585, 587, 26 L. Ed. 492; Legal Tender Case, 110 U. S. 421, 444, 4 Sup. Ct. 122, 28 L. Ed. 204; Lithograph Co. v. Sarony, 111 U. S. 53, 58, 4 Sup. Ct. 279, 28 L. Ed. 349; United States v. Realty Co., 163 U. S. 427, 440, 441, 442, 16 Sup. Ct. 1120, 41 L. Ed. 215; South Carolina v. United States, 199 U. S. 437, 448, 449, 26 Sup. Ct. 110, 50 L. Ed. 261, 4 Ann. Cas. 737. Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?

First. The term 'income,' when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. If the dividend is declared payable in cash, the money with which to pay it is ordinarily taken from surplus cash in the treasury. But (if there are profits legally available for distribution and the law under which the company was incorporated so permits) the company may raise the money by discounting negotiable paper; or by selling bonds, scrip or stock of another corporation then in the treasury; or by selling its own bonds, scrip or stock then in the treasury; or by selling its own bonds, scrip or stock issued expressly for that purpose. How the money shall be raised is wholly a matter of financial management. The manner in which it is raised in no way affects the question whether the dividend received by the stockholder is income or capital; nor can it conceivably affect the question whether it is taxable as income.

Likewise whether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management whether the distribution shall be, for instance, in bonds, scrip or stock of another corporation or in issues of its own. And if the dividend is paid in its own issues, why should there be a difference in result dependent upon whether the distribution was made from such securities then in the treasury or from others to be created and issued by the company expressly for that purpose? So far as the distribution may be made from its own issues of bonds, or preferred stock created expressly for the purpose, it clearly would make no difference in the decision of the question whether the dividend was a distribution of profits, that the securities had to be created expressly for the purpose of distribution. If a dividend paid in securities of that nature represents a distribution of profits Congress may, of course, tax it as income of the stockholder. Is the result different where the security distributed is common stock?

Suppose that a corporation having power to buy and sell its own stock, purchases, in the interval between its

regular dividend dates, with moneys derived from current profits, some of its own common stock as a temporary investment, intending at the time of purchase to sell it before the next dividend date and to use the proceeds in paying dividends, but later, deeming it inadvisable either to sell this stock or to raise by borrowing the money necessary to pay the regular dividend in cash, declares a dividend payable in this stock; can any one doubt that in such a case the dividend in common stock would be income of the stockholder and constitutionally taxable as such? See Green v. Bissell, 79 Conn. 547, 65 Atl. 1056, 8 L. R. A. (N. S.) 1011, 118 Am. St. Rep. 156, 9 Ann. Cas. 287; Leland v. Hayden, 102 Mass. 542. And would it not likewise be income of the stockholder subject to taxation if the purpose of the company in buying the stock so distributed had been from the beginning to take it off the market and distribute it among the stockholders as a dividend, and the company actually did so? And proceeding a short step further: Suppose that a corporation decided to capitalize some of its accumulated profits by creating additional common stock and selling the same to raise working capital, but after the stock has been issued and certificates therefor are delivered to the bankers for sale, general financial conditions make it undesirable to market the stock and the company concludes that it is wiser to husband, for working capital, the cash which it had intended to use in paying stockholders a dividend, and, instead, to pay the dividend in the common stock which it had planned to sell; would not the stock so distributed be a distribution of profits--and hence, when received, be income of the stockholder and taxable as such? If this be conceded, why should it not be equally income of the stockholder, and taxable as such, if the common stock created by capitalizing profits, had been originally created for the express purpose of being distributed as a dividend to the stockholder who afterwards received it?

Second. It has been said that a dividend payable in bonds or preferred stock created for the purpose of distributing profits may be income and taxable as such, but that the case is different where the distribution is in common stock created for that purpose. Various reasons are assigned for making this distinction. One is that the proportion of the stockholder's ownership to the aggregate number of the shares of the company is not changed by the distribution. But that is equally true where the dividend is paid in its bonds or in its preferred stock. Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved. Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder after receipt of the stock dividend has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property, for instance, bonds, scrip or preferred stock of the company. The payment from profits of a large cash dividend, and even a small one, customarily lowers the then market value of stock because the undivided property represented by each share has been correspondingly reduced. The argument which appears to be most strongly urged for the stockholders is, that when a stock dividend is made, no portion of the assets of the company is thereby segregated for the stockholder. But does the issue of new bonds or of preferred stock created for use as a dividend result in any segregation of assets for the stockholder? In each case he receives a piece of paper which entitles him to certain rights in the undivided property. Clearly segregation of assets in a physical sense is not an essential of income. The year's gains of a partner is taxable as income, although there, likewise, no segregation of his share in the gains from that of his partners is had.

The objection that there has been no segregation is presented also in another form. It is argued that until there is a segregation, the stockholder cannot know whether he has really received gains; since the gains may be invested in plant or merchandise or other property and perhaps be later lost. But is not this equally true of the share of a partner in the year's profits of the firm or, indeed, of the profits of the individual who is engaged in business alone? And is it not true, also, when dividends are paid in cash? The gains of a business, whether conducted by an individual, by a firm or by a corporation, are ordinarily reinvested in large part. Many a cash dividend honestly declared as a distribution of profits, proves later to have been paid out of capital, because errors in forecast prevent correct ascertainment of values. Until a business adventure has been completely

liquidated, it can never be determined with certainty whether there have been profits unless the returns at least exceeded the capital originally invested. Business men, dealing with the problem practically, fix necessarily periods and rules for determining whether there have been net profits--that is, income or gains. They protect themselves from being seriously misled by adopting a system of depreciation charges and reserves. Then, they act upon their own determination, whether profits have been made. Congress in legislating has wisely adopted their practices as its own rules of action.

Third. The Government urges that it would have been within the power of Congress to have taxed as income of the stockholder his pro rata share of undistributed profits earned, even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. See The Collector v. Hubbard, 12 Wall. 1, 20 L. Ed. 272. The undivided share of a partner in the year's undistributed profits of his firm is taxable as income of the partner, although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. Linn Timber Co. v. United States, 236 U. S. 574, 35 Sup. Ct. 440, 59 L. Ed. 725. See Morawetz on Corporations (2d Ed.) §§ 227-231; Cook on Corporations (7th Ed.) §§ 663, 664. The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporations. [FN5] No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. In other words to render the stockholder taxable there must be both earnings made *and* a dividend paid. Neither earnings without dividend--nor a dividend without earnings--subjects the stockholder to taxation under the Revenue Act of 1916.

Fourth. The equivalency of all dividends representing profits, whether paid of all dividends in stock, is so complete that serious question of the taxability of stock dividends would probably never have been made, if Congress had undertaken to tax only those dividends which represented profits earned during the year in which the dividend was paid or in the year preceding. But this court, construing liberally, not only the constitutional grant of power, but also the revenue act of 1913, held that Congress might tax, and had taxed, to the stockholder dividends received during the year, although earned by the company long before; and even prior to the adoption of the Sixteenth Amendment. Lynch v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149. [FN6] That rule, if indiscriminatingly applied to all stock dividends representing profits earned, might, in view of corporate practice, have worked considerable hardship, and have raised serious questions. Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to 'surplus' account--distinguishing between such permanent 'surplus' and the 'undivided profits' account. Other corporations, without this formality, had assumed that the annual accumulating balances carried as undistributed profits were to be treated as capital permanently invested in the business. And still others, without definite assumption of any kind, had so used undivided profits for capital purposes. To have made the revenue law apply retroactively so as to reach such accumulated profits, if and whenever it should be deemed desirable to capitalize them legally by the issue of additional stock distributed as a dividend to stockholders, would have worked great injustice. Congress endeavored in the Revenue Act of 1916 to guard against any

serious hardship which might otherwise have arisen from making taxable stock dividends representing accumulated profits. It did not limit the taxability to stock dividends representing profits earned within the tax year or in the year preceding; but it did limit taxability to such dividends representing profits earned since March 1, 1913. Thereby stockholders were given notice that their share also in undistributed profits accumulating thereafter was at some time to be taxed as income. And Congress sought by section 3 (Comp. St. 1918, Comp. St. Ann. Supp. 1919, § 6336c) to discourage the postponement of distribution for the illegitimate purpose of evading liability to surtaxes.

Fifth. The decision of this court, that earnings made before the adoption of the Sixteenth Amendment, but paid out in cash dividend after its adoption, were taxable as income of the stockholder, involved a very liberal construction of the amendment. To hold now that earnings both made and paid out after the adoption of the Sixteenth Amendment cannot be taxed as income of the stockholder, if paid in the form of a stock dividend, involves an exceedingly narrow construction of it. As said by Mr. Chief Justice Marshall in Brown v. Maryland, 12 Wheat. 419, 446 (6 L. Ed. 678):

> 'To construe the power so as to impair its efficacy, would tend to defeat an object, in the attainment of which the American public took, and justly took, that strong interest which arose from a full conviction of its necessity.'

No decision heretofore rendered by this court requires us to hold that Congress, in providing for the taxation of stock dividends, exceeded the power conferred upon it by the Sixteenth Amendment. The two cases mainly relied upon to show that this was beyond the power of Congress are Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372 L. R. A. 1918D, 254, which involved a question not of constitutional power but of statutory construction, and Gibbons v. Mahon, 136 U. S. 549, 10 Sup. Ct. 1057, 34 L. Ed. 525, which involved a question arising between life tenant and remainderman. So far as concerns Towne v. Eisner we have only to bear in mind what was there said (245 U. S. 425, 38 Sup. Ct. 159, 62 L. Ed. 372, L. R. A. 1918D, 254): 'But it is not necessarily true that income means the same thing in the Constitution and the [an] act.' [FN7] Gibbons v. Mahon is even less an authority for a narrow construction of the power to tax incomes conferred by the Sixteenth Amendment. In that case the court was required to determine how, in the administration of an estate in the District of Columbia, a stock dividend, representing profits, received after the decedent's death, should be disposed of as between life tenant and remainderman. The question was in essence: What shall the intention of the testator be presumed to have been? On this question there was great diversity of opinion and practice in the courts of English-speaking countries. Three well-defined rules were then competing for acceptance; two of these involves an arbitrary rule of distribution, the third equitable apportionment. See Cook on Corporations (7th Ed.) §§ 552-558.

1. The so-called English rule, declared in 1799, by Brander v. Brander, 4 Ves. Jr. 800, that a dividend representing profits, whether in cash, stock or other property, belongs to the life tenant if it was a regular or ordinary dividend, and belongs to the remainderman if it was an extraordinary dividend.

2. The so-called Massachusetts rule, declared in 1868 by Minot v. Paine, 99 Mass. 101, 96 Am. Dec. 705, that a dividend representing profits, whether regular, ordinary or extraordinary, if in cash belongs to the life tenant, and if in stock belongs to the remainderman.

3. The so-called Pennsylvania rule declared in 1857 by Earp's Appeal, 28 Pa. 368, that where a stock dividend is paid, the court shall inquire into the circumstances under which the fund had been earned and accumulated out of which the dividend, whether a regular, an ordinary or an extraordinary one, was paid. If it finds that the

stock dividend was paid out of profits earned since the decedent's death, the stock dividend belongs to the life tenant; if the court finds that the stock dividend was paid from capital or from profits earned before the decedent's death, the stock dividend belongs to the remainderman.

This court adopted in Gibbons v. Mahon as the rule of administration for the District of Columbia the so-called Massachusetts rule, the opinion being delivered in 1890 by Mr. Justice Gray. Since then the same question has come up for decision in many of the states. The so-called Massachusetts rule, although approved by this court, has found favor in only a few states. The so-called Pennsylvania rule, on the other hand, has been adopted since by so many of the states (including New York and California), that it has come to be known as the 'American rule.' Whether, in view of these facts and the practical results of the operation of the two rules as shown by the experience of the 30 years which have elapsed since the decision in Gibbons v. Mahon, it might be desirable for this court to reconsider the question there decided, as some other courts have done (see 29 Harvard Law Review, 551), we have no occasion to consider in this case. For, as this court there pointed out (136 U. S. 560, 1059 [34 L. Ed. 525]), the question involved was one 'between the owners of successive interests in particular shares,' and not, as in Bailey v. Railroad Co., 22 Wall. 604, 22 L. Ed. 840, a question 'between the corporation and the government, and [which] depended upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings.'

We have, however, not merely argument; we have examples which should convince us that 'there is no inherent, necessary and immutable reason why stock dividends should always be treated as capital.' Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, L. R. A. 1917F. 806. The Supreme Judical Court of Massachusetts has steadfastly adhered, despite ever-renewed protest, to the rule that every stock dividend is, as between life tenant and remainderman, capital and not income. But in construing the Massachusetts Income Tax Amendment, which is substantially identical with the federal amendment, that court held that the Legislature was thereby empowered to levy an income tax upon stock dividends representing profits. The courts of England have, with some relaxation, adhered to their rule that every extraordinary dividend is, as between life tenant and remainderman, to be deemed capital. But in 1913 the Judicial Committee of the Privy Council held that a stock dividend representing accumulated profits was taxable like an ordinary cash dividend, Swan Brewery Company, Limited v. The King, L. R. 1914 A. C. 231. In dismissing the appeal these words of the Chief Justice of the Supreme Court of Western Australia were quoted (page 236) which show that the facts involved were identical with those in the case at bar:

'Had the company distributed the <<PoundsSterling>>101,450 among the shareholders and had the shareholders repaid such sums to the company as the price of the 81,160 new SHARES, THE DUTY ON THE <<PoundsSterling>> 101,450WOULD CLEARLY HAVE BEEN PAYable. is not this virtually the effect of what was actually done? I think it is.'

Sixth. If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends they will pay these taxes not upon their income but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed. [FN8] In terse, comprehensive language befitting the Constitution, they empowered Congress 'to lay and collect taxes on incomes from whatever source derived.' They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded, not only by the plain people, but by investors and financiers, and by most of the courts of the country, is shown, beyond peradventure, by their acts and by their utterances. It seems to me clear, therefore, that Congress

possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. And, as this court has so often said, the high prerogative of declaring an act of Congress invalid, should never be exercised except in a clear case. [FN9]

Mr. Justice CLARKE concurs in this opinion.

Footnotes:

FN1 Title I.--Income Tax.

Part I.--On Individuals.

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived, * * * also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: Provided, that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, * * * which stock dividend shall be considered income, to the amount of its cash value.

FN2 Moody's p. 1544; Commercial and Financial Chronicle, vol. 94, p. 831; vol. 98, pp. 1005, 1076.

FN3 Moody's, p. 1548; Commercial and Financial Chronicle, vol. 94, p. 771; vol. 96, p. 1428; vol. 97, p. 1434; vol. 98, p. 1541.

FN4 Moody's, p. 1547; Commercial and Financial Chronicle, vol. 97, pp. 1589, 1827, 1903; vol. 98, pp. 76, 457; vol. 103, p. 2348. Poor's Manual of Industrials (1918), p. 2240, in giving the 'comparative income account' of the company, describes the 1914 dividend as 'stock dividend paid (200 per cent.)--$2,000,000,' and describes the 1917 dividend as $3,000,000 special cash dividend.'

FN5 See Some Judicial Myths, by Francis M. Burdick, 22 Harvard Law Review, 393, 394-396; The Firm as a Legal Person, by William Hamilton Cowles, 57 Cent. L. J., 343, 348; The Separate Estates of Non-Bankrupt Partners, by J. D. Brannan, 20 Harvard Law Review, 589-592. Compare Harvard Law Review, vol. 7, p. 426; vol. 14, p. 222; vol. 17, p. 194.

FN6 The hardship supposed to have resulted from such a decision has been removed in the Revenue Act of 1916 as amended, by providing in section 31b (Comp. St. 1918, Comp. St. Ann. Supp. 1919, § 6336z) that such cash dividends shall thereafter be exempt from taxation, if before they are made all earnings made since February 28, 1913, shall have been distributed. Act Oct. 3, 1917, c. 63, § 1211, 40 Stat. 338, Act Feb. 24, 1919, c. 18, § 201(b), 40 Stat. 1059 (Comp. St. Ann. Supp. 1919, § 6336 1/8 b).

FN7 Compare Rugg, C. J., in Tax Commissioner v. Putnam, 227 Mass. 522, 533, 116 N. E. 904, 910 (L. R. A. 1917F, 806): 'However strong such an argument might be when urged as to the interpretation of a statute, it is not of prevailing force as to the broad considerations involved in the interpretation of an amendment to the Constitution adopted under the conditions preceding and attendant upon the ratification of the forty-fourth amendment.'

FN8 Compare Rugg, C. J., Tax Commissioner v. Putnam, 227 Mass. 522, 524, 116 N. E. 904, 910 (L. R. A. 1917F, 806): 'It is a grant from the sovereign people and not the exercise of a delegated power. It is a statement of general principles and not a specification of details. Amendments to such a charter of government ought to be construed in the same spirit and according to the same rules as the original. It is to be interpreted as the Constitution of a state and not as a statute or an ordinary piece of legislation. Its words must be given a construction adapted to carry into effect its purpose.'

FN9 'It is our duty, when required in the regular course of judicial proceedings, to declare an act of Congress void if not within the legislative power of the United States; but this declaration should never be made except in a clear case. Every possible presumption is in favor of the validity of a statute, and this continues until the contrary is shown beyond a rational doubt. One branch of the government cannot encroach on the domain of another without danger. The safety of our institutions depends in no small degree on a strict observance of this salutary rule.' The 'Sinking Fund Cases, 99 U. S. 700, 718, 25 L. Ed. 496 (1878). See also Legal Tender Cases, 12 Wall. 457, 531, 20 L. Ed. 287 (1870); Trade Mark Cases, 100 U. S. 82, 96, 25 L. Ed. 550 (1879). See American Doctrine of Constitutional Law by James B. Thayer, 7 Harvard Law Review, 129, 142.

'With the exception of the extraordinary decree rendered in the Dred Scott Case, * * * all of the acts or the portions of the acts of Congress invalidated by the courts before 1868 related to the organization of courts. Denying the power of Congress to make notes legal tender seems to be the first departure from this rule.' Haines, American Doctrine of Judicial Supremacy, p. 288. The first legal tender decision was overruled in part two years later (1870), Legal Tender Cases, 12 Wall. 457, 20 L. Ed. 287; and again in 1883, Legal Tender Case, 110 U. S. 421, 4 Sup. Ct. 122, 28 L. Ed. 204.

'It is but a decent respect due to the wisdom, the integrity and the patriotism of the legislative body, by which any law is passed, to presume in favor of its validity, until its violation of the Constitution is proved beyond all reasonable doubt.' Ogden v. Saunders, 12 Wheat. 213, 269, 6 L.Ed. 606.

Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, 41 S.Ct. 386 (1921)

Supreme Court of the United States

MERCHANTS' LOAN & TRUST CO.

v.

SMIETANKA.

No. 608.

Argued Jan. 11 and 12, 1921.

Decided March 28, 1921.

Mr. Justice CLARKE delivered the opinion of the Court.

A writ of error brings this case here for review of a judgment of the District Court of the United States for the Northern District of Illinois, sustaining a demurrer to a declaration in assumpsit to recover an assessment of taxes for the year 1917, made under warrant of the Income Tax Act of Congress, approved September 8, 1916 (39 Stat. c. 463, p. 756), as amended by the act approved October 3, 1917 (40 Stat. c. 63, p. 300). Payment was made under protest, and the claim to recover is based upon the contention that the fund taxed was not 'income' within the scope of the Sixteenth Amendment to the Constitution of the United States, and that the effect given by the lower court to the act of Congress cited renders it unconstitutional and void. This is sufficient to sustain the writ of error. Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158, 62 L. Ed. 372, L. R. A. 1918B, 254.

Arthur Ryerson died in 1912, and the plaintiff in error is trustee under his will of property the net income of which was directed to be paid to his widow during her life and after her death to be used for the benefit of his children, or their representatives, until each child should arrive at 25 years of age, when each should receive his or her share of the trust fund.

The trustee was given the fullest possible dominion over the trust estate. It was made the final judge as to what 'net income' of the estate should be, and its determination in this respect was made binding upon all parties interested therein, 'except that it is my will that stock dividends and accretions of selling values shall be considered principal and not income.'

The widow and four children were living in 1917.

Among the assets which came to the custody of the trustee were 9,522 shares of the capital stock of Joseph T. Ryerson & Son, a corporation. It is averred that the cash value of these shares, on March 1, 1913, was $561,798, and that they were sold for $1,280,996.64, on February 2, 1917. The Commissioner of Internal Revenue treated the difference between the value of the stock on March 1, 1913, and the amount for which it was sold on February 2, 1917, as income for the year 1917, and upon that amount assessed the tax which was

paid. No question is made as to the amount of the tax if the collection of it was lawful.

The ground of the protest, and the argument for the plaintiff in error here, is that the sum charged as 'income' represented appreciation in the value of the capital assets of the estate which was not 'income' within the meaning of the Sixteenth Amendment, and therefore could not constitutionally be taxed, without apportionment, as required by section 2, clause 3, and by section 9, clause 4, of article 1 of the Constitution of the United States.

It is first argued that the increase in value of the stock could not be lawfully taxed under the act of Congress because it was not income to the widow, for she did not receive it in 1917, and never can receive it, that it was not income in that year to the children for they did not then, and may never, receive it, and that it was not income to the trustee, not only because the will creating the trust required that 'stock dividends and accretions of selling value shall be considered principal and not income,' but also because in the 'common understanding' the term 'income' does not comprehend such a gain or profit as we have here, which it is contended is really an accretion to capital and therefore not constitutionally taxable under Eisner v. Macomber, 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570.

The provision of the will may be disregarded. It was not within the power of the testator to render the fund nontaxable.

Assuming for the present that there was constitutional power to tax such a gain or profit as is here involved, are the terms of the statute comprehensive enough to include it?

Section 2(a) of the act of September 8, 1916 (39 Stat. 757), (40 Stat. 300, 307, § 212), applicable to the case, defines the income of 'a taxable person' as including 'gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property * * * or gains or profits and income derived from any source whatever.'

Plainly the gain we are considering was derived from the sale of personal property, and, very certainly the comprehensive last clause 'gains or profits and income derived from any source whatever,' must also include it, if the trustee was a 'taxable person' within the meaning of the act when the assessment was made.

That the trustee was such a 'taxable person' is clear from section 1204(1)(c) of the act of October 3, 1917 (40 Stat. 331), which requires that----

'Trustees, executors * * * and all persons, corporations, or associations, acting in any fiduciary capacity shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals.'

And section 2(b) of the act of September 8, 1916, supra, specifically declares that the----

> 'income received by estates of deceased persons during the period of administration or settlement of the estate, * * * or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the

> purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be.'

Further, section 2(c) clearly shows that it was the purpose of Congress to tax gains, derived from such a sale as we have here, in the manner in which this fund was assessed, by providing that----

> 'For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived.'

Thus, it is the plainly expressed purpose of the act of Congress to treat such a trustee as we have here as a 'taxable person' and for the purposes of the act to deal with the income received for others precisely as if the beneficiaries had received it in person.

There remains the question, strenuously argued, whether this gain in four years of over $700,000 on an investment of about $500,000 is 'income' within the meaning of the Sixteenth Amendment to the Constitution of the United States.

The question is one of definition, and the answer to it may be found in recent decisions of this Court.

The Corporation Excise Tax Act of August 5, 1909 (36 Stat. 11, 112), was not an income tax law, but a definition of the word 'income' was so necessary in its administration that in an early case it was formulated as 'A gain derived from capital, from labor, or from both combined.' Stratton's Independence v. Howbert, 231 U. S. 399, 415, 34 Sup. Ct. 136, 140 (58 L. Ed. 285).

This definition, frequently approved by this court, received an addition, in its latest income tax decision, which is especially significant in its application to such a case as we have here, so that it now reads:

> 'Income may be defined as a gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets.' Eisner v. Macomber, 252 U. S. 189, 207, 40 Sup. Ct. 189, 193 (64 L. Ed. 521), 9 A. L. R. 1570.

The use made of this definition of 'income' in the decision of cases arising under the Corporation Excise Tax Act of August 5, 1909, and under the Income Tax Acts, is, we think, decisive of the case before us. Thus, in two cases arising under the Corporation Excise Tax Act:

In Hays v. Gauley Mountain Coal Co., 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061, a coal company, without corporate authority to trade in stocks, purchased shares in another coal mining company in 1902, which it sold in 1911, realizing a profit of $210,000. Over the same objection made in this case, that the fund was merely converted capital, this court held that so much of the profit upon the sale of the stock as accrued subsequent to the effective date of the act was properly treated as income received during 1911, in assessing the tax for that year.

In United States v. Cleveland, Cincinnati, Chicago & St. Louis Railway Co., 247 U. S. 195, 38 Sup. Ct. 472, 62 L. Ed. 1064, a railroad company purchased shares of stock in another railroad company in 1900, which it

sold in 1909, realizing a profit of $814,000. Here, again, over the same objection, this court held that the part of the profit which accrued subsequent to the effective date of the act was properly treated as income received during the year 1909 for the purposes of the act.

Thus, from the price realized from the sale of stock by two investors, as distinguished from dealers, and from a single transaction as distinguished from a course of business, the value of the stock on the effective date of the tax act was deducted, and the resulting gain was treated by this court as 'income' by which the tax was measured.

It is obvious that these decisions in principle rule the case at bar if the word 'income' has the same meaning in the Income Tax Act of 1913 that it had in the Corporation Excise Tax Act of 1909, and that it has the same scope of meaning was in effect decided in Southern Pacific Co. v. Lowe, 247 U. S. 330, 335, 38 Sup. Ct. 540, 62 L. Ed. 1142, where it was assumed for the purposes of decision that there was no difference in its meaning as used in the act of 1909 and in the Income Tax Act of 1913 (38 Stat. 114). There can be no doubt that the word must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the act of 1913. When to this we add that in Eisner v. Macomber, supra, a case arising under the same Income Tax Act of 1916 which is here involved, the definition of 'income' which was applied was adopted from Stratton's Independence v. Howbert, supra, arising under the Corporation Excise Tax Act of 1909, with the addition that it should include 'profit gained through sale or conversion of capital assets,' there would seem to be no room to doubt that the word must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Corporation Excise Tax Act, and that what that meaning is has now become definitely settled by decisions of this Court.

In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution. Doyle v. Mitchell Brothers Co., 247 U. S. 179, 185, 38 Sup. Ct. 467, 62 L. Ed. 1054; Eisner v. Macomber, 252 U. S. 189, 206, 207, 40 Sup. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570. Notwithstanding the full argument heard in this case and in the series of cases now under consideration, we continue entirely satisfied with that definition, and, since the fund here taxed was the amount realized from the sale of the stock in 1917, less the capital investment as determined by the trustee as of March 1, 1913, it is palpable that it was a 'gain or profit' 'produced by' or 'derived from' that investment, and that it 'proceeded' and was 'severed' or rendered severable from it by the sale for cash, and thereby became that 'realized gain' which has been repeatedly declared to be taxable income within the meaning of the constitutional amendment and the acts of Congress. Doyle v. Mitchell Brothers Co. and Eisner v. Macomber, supra.

It is elaborately argued in this case, in No. 609, Eldorado Coal & Mining Co. v. Harry W. Mager, Collector, etc., submitted with it, and in other cases since argued, that the word 'income' as used in the Sixteenth Amendment and in the Income Tax Act we are considering does not include the gain from capital realized by a single isolated sale of property, but that only the profits realized from sales by one engaged in buying and selling as a business--a merchant, a real estate agent, or broker--constitute income which may be taxed.

It is sufficient to say of this contention that no such distinction was recognized in the Civil War Income Tax Act of 1867 (14 Stat. 471, 478), or in the act of 1894 (28 Stat. 509, 553), declared unconstitutional on an unrelated ground; that it was not recognized in determining income under the Excise Tax Act of 1909, as the cases cited, supra, show; that it is not to be found, in terms, in any of the income tax provisions of the Internal

Revenue Acts of 1913, 1916, 1917, or 1919 (40 Stat. 1057); that the definition of the word 'income' as used in the Sixteenth Amendment, which has been developed by this Court, does not recognize any such distinction; that in departmental practice, for now seven years, such a rule has not been applied; and that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. The interesting and ingenious argument, which is earnestly pressed upon us, that this distinction is so fundamental and obvious that it must be assumed to be a part of the 'general understanding' of the meaning of the word 'income,' fails to convince us that a construction should be adopted which would, in a large measure, defeat the purpose of the amendment.

The opinions of the courts in dealing with the rights of life tenants and remaindermen in gains derived from invested capital, especially in dividends paid by corporations, are of little value in determining such a question as we have here, influenced as such decisions are by the terms of the instruments creating the trusts involved and by the various rules adopted in the various jurisdictions for attaining results thought to be equitable. Here the trustee, acting within its powers, sold the stock, as it might have sold a building, and realized a profit of $700,000, which at once became assets in its possession free for any disposition within the scope of the trust, but for the purposes of taxation to be treated as if the trustee were the sole owner.

Gray v. Darlington, 15 Wall. 63, 21 L. Ed. 45, much relied upon in argument, was sufficiently distinguished from cases such as we have here in Hays v. Gauley Mountain Coal Co., 247 U. S. 189, 191, 38 Sup. Ct. 470, 62 L. Ed. 1061. The differences in the statutes involved render inapplicable the expressions in the opinion in that case (not necessary to the decision of it) as to distinctions between income and increase of capital.

In Lynch v. Turrish, 247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087, also much relied upon, it is expressly stated that----

> 'According to the fact admitted, there was no increase after that date [March 1, 1913], and therefore no increase subject to the law.'

For this reason the questions here discussed and decided were not there presented.

The British income tax decisions are interpretations of statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved.

Another assessment on a small gain realized upon a purchase, made in 1914, of bonds which were duly called for redemption and paid in 1917, does not present any questions other than those which we have discussed, and therefore it does not call for separate consideration.

The judgment of the District Court is

Affirmed.

Mr. Justice HOLMES and Mr. Justice BRANDEIS, because of prior decisions of the Court, concur in the judgment.

§ 3002. Definitions

How Current is This?

As used in this chapter:

(1) "Counsel for the United States" means—

(A) a United States attorney, an assistant United States attorney designated to act on behalf of the United States attorney, or an attorney with the United States Department of Justice or with a Federal agency who has litigation authority; and

(B) any private attorney authorized by contract made in accordance with section 3718 of title 31 to conduct litigation for collection of debts on behalf of the United States.

(2) "Court" means any court created by the Congress of the United States, excluding the United States Tax Court.

(3) "Debt" means—

(A) an amount that is owing to the United States on account of a direct loan, or loan insured or guaranteed, by the United States; or

(B) an amount that is owing to the United States on account of a fee, duty, lease, rent, service, sale of real or personal property, overpayment, fine, assessment, penalty, restitution, damages, interest, tax, bail bond forfeiture, reimbursement, recovery of a cost incurred by the United States, or other source of indebtedness to the United States, but that is not owing under the terms of a contract originally entered into by only persons other than the United States;

and includes any amount owing to the United States for the benefit of an Indian tribe or individual Indian, but excludes any amount to which the United States is entitled under section 3011 (a).

(4) "Debtor" means a person who is liable for a debt or against whom there is a claim for a debt.

(5) "Disposable earnings" means that part of earnings remaining after all deductions required by law have been withheld.

(6) "Earnings" means compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program.

(7) "Garnishee" means a person (other than the debtor) who has, or is reasonably thought to have, possession, custody, or control of any property in which the debtor has a substantial nonexempt interest, including any obligation due the debtor or to become due the debtor, and against whom a garnishment under section 3104 or 3205 is issued by a court.

(8) "Judgment" means a judgment, order, or decree entered in favor of the United States in a court and arising from a civil or criminal proceeding regarding a debt.

(9) "Nonexempt disposable earnings" means 25 percent of disposable earnings, subject to section 303 of the Consumer Credit Protection Act.

(10) "Person" includes a natural person (including an individual Indian), a corporation, a partnership, an unincorporated association, a trust, or an estate, or any other public or private entity, including a State or local government or an Indian tribe.

(11) "Prejudgment remedy" means the remedy of attachment, receivership, garnishment, or sequestration authorized by this chapter to be granted before judgment on the merits of a claim for a debt.

(12) "Property" includes any present or future interest, whether legal or equitable, in real, personal (including choses in action), or mixed property, tangible or intangible, vested or contingent, wherever located and however held (including community property and property held in trust (including spendthrift and pension trusts)), but excludes—

(A) property held in trust by the United States for the benefit of an Indian tribe or individual Indian; and

(B) Indian lands subject to restrictions against alienation imposed by the United States.

(13) "Security agreement" means an agreement that creates or provides for a lien.

(14) "State" means any of the several States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Marianas, or any territory or possession of the United States.

(15) "United States" means—

(A) a Federal corporation;

(B) an agency, department, commission, board, or other entity of the United States; or

(C) an instrumentality of the United States.

(16) "United States marshal" means a United States marshal, a deputy marshal, or an official of the United States Marshals Service designated under section 564.

Prev | Next

Sec. 3002. - Definitions

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(B)

any private attorney authorized by contract made in accordance with section 3718 of title 31 to conduct litigation for collection of debts on behalf of the United States.

(2)

''Court'' means any court created by the Congress of the United States, excluding the United States Tax Court.

(3)

''Debt'' means -

(A)

an amount that is owing to the United States on account of a direct loan, or loan insured or guaranteed, by the United States; or

(B)

an amount that is owing to the United States on

account of a fee, duty, lease, rent, service, sale of real or personal property, overpayment, fine, assessment, penalty, restitution, damages, interest, tax, bail bond forfeiture, reimbursement, recovery of a cost incurred by the United States, or other source of indebtedness to the United States, but that is not owing under the terms of a contract originally entered into by only persons other than the United States;

and includes any amount owing to the United States for the benefit of an Indian tribe or individual Indian, but excludes any amount to which the United States is entitled under section 3011(a).

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''Disposable earnings'' means that part of earnings remaining after all deductions required by law have been withheld.

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''Earnings'' means compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program.

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''Garnishee'' means a person (other than the debtor) who has, or is reasonably thought to have, possession, custody, or control of any property in which the debtor has a substantial nonexempt interest, including any obligation due the debtor or to become due the debtor, and against whom a garnishment under section 3104 or 3205 is issued by a court.

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''Prejudgment remedy'' means the remedy of attachment, receivership, garnishment, or sequestration authorized by this chapter to be granted before judgment on the merits of a claim for a debt.

(12)

''Property'' includes any present or future interest, whether legal or equitable, in real, personal (including choses in action), or mixed property, tangible or intangible, vested or contingent, wherever located and however held (including community property and property held in trust (including spendthrift and pension trusts)), but excludes -

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property held in trust by the United States for the benefit of an Indian tribe or individual Indian; and

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Indian lands subject to restrictions against alienation imposed by the United States.

(13)

''Security agreement'' means an agreement that creates or provides for a lien.

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''State'' means any of the several States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Marianas, or any territory or possession of the United States.

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(C)

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''United States marshal'' means a United States marshal, a deputy marshal, or an official of the United States Marshals Service designated under section 564

Prev | Next

Code **Sec. 1.1441-1 Requirement for the deduction and withholding of tax on payments to foreign persons.**

(a) Purpose and scope.

This section, Secs. 1.1441-2 through 1.1441-9, and 1.1443-1 provide rules for withholding under sections 1441, 1442, and 1443 when a payment is made to a foreign person. This section provides definitions of terms used in chapter 3 of the Internal Revenue Code (Code) and regulations thereunder. It prescribes procedures to determine whether an amount must be withheld under chapter 3 of the Code and documentation that a withholding agent may rely upon to determine the status of a payee or a beneficial owner as a U.S. person or as a foreign person and other relevant characteristics of the payee that may affect a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder. Special procedures regarding payments to foreign persons that act as intermediaries are also provided. Section 1.1441-2 defines the income subject to withholding under section 1441, 1442, and 1443 and the regulations under these sections. Section 1.1441-3 provides rules regarding the amount subject to withholding. Section 1.1441-4 provides exemptions from withholding for, among other things, certain income effectively connected with the conduct of a trade or business in the United States, including certain compensation for the personal services of an individual. Section 1.1441-5 provides rules for withholding on payments made to flow-through entities and other similar arrangements. Section 1.1441-6 provides rules for claiming a reduced rate of withholding under an income tax treaty. Section 1.1441-7 defines the term withholding agent and provides due diligence rules governing a withholding agent's obligation to withhold. Section 1.1441-8 provides rules for relying on claims of exemption from withholding for payments to a foreign government, an international organization, a foreign central bank of issue, or the Bank for International Settlements. Sections 1.1441-9 and 1.1443-1 provide rules for relying on claims of exemption from withholding for payments to foreign tax exempt organizations and foreign private foundations.

(b) General rules of withholding.

(1) Requirement to withhold on payments to foreign persons.

A withholding agent must withhold 30-percent of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. However, a withholding agent making a payment to a foreign person need not

withhold where the foreign person assumes responsibility for withholding on the payment under chapter 3 of the Code and the regulations thereunder as a qualified intermediary (see paragraph (e)(5) of this section), as a U.S. branch of a foreign person (see paragraph (b)(2)(iv) of this section), as a withholding foreign partnership (see Sec. 1.1441-5(c)(2)(i)), or as an authorized foreign agent (see Sec. 1.1441-7(c)(1)). This section (dealing with general rules of withholding and claims of foreign or U.S. status by a payee or a beneficial owner), and Secs. 1.1441-4, 1.1441-5, 1.1441-6, 1.1441-8, 1.1441-9, and 1.1443-1 provide rules for determining whether documentation is required as a condition for reducing the rate of withholding on a payment to a foreign beneficial owner or to a U.S. payee and if so, the nature of the documentation upon which a withholding agent may rely in order to reduce such rate. Paragraph (b)(2) of this section prescribes the rules for determining who the payee is, the extent to which a payment is treated as made to a foreign payee, and reliable association of a payment with documentation. Paragraph (b)(3) of this section describes the applicable presumptions for determining the payee's status as U.S. or foreign and the payee's other characteristics (i.e., as an owner or intermediary, as an individual, partnership, corporation, etc.). Paragraph (b)(4) of this section lists the types of payments for which the 30-percent withholding rate may be reduced. Because the treatment of a payee as a U.S. or a foreign person also has consequences for purposes of making an information return under the provisions of chapter 61 of the Code and for withholding under other provisions of the Code, such as sections 3402, 3405 or 3406, paragraph (b)(5) of this section lists applicable provisions outside chapter 3 of the Code that require certain payees to establish their foreign status (e.g., in order to be exempt from information reporting). Paragraph (b)(6) of this section describes the withholding obligations of a foreign person making a payment that it has received in its capacity as an intermediary. Paragraph (b)(7) of this section describes the liability of a withholding agent that fails to withhold at the required 30-percent rate in the absence of documentation. Paragraph (b)(8) of this section deals with adjustments and refunds in the case of overwithholding. Paragraph (b)(9) of this section deals with determining the status of the payee when the payment is jointly owned. See paragraph (c)(6) of this section for a definition of beneficial owner. See Sec. 1.1441-7(a) for a definition of withholding agent. See Sec. 1.1441-2(a) for the determination of an amount subject to withholding. See Sec. 1.1441-2(e) for the definition of a payment and when it is considered made. Except as otherwise provided, the provisions of this section apply only for purposes of determining a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder.

(2) Determination of payee and payee's status.

(i) In general.

Except as otherwise provided in this paragraph (b)(2) and Sec. 1.1441- 5(c)(1) and (e)(3), a payee is the person to whom a payment is made, regardless of whether such person is the beneficial owner of the amount (as defined in paragraph (c)(6) of this section). A foreign payee is a payee who is a foreign person. A U.S. payee is a payee who is a U.S. person. Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is a Form W-8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W-9 (indicating U.S. status of the payee). The provisions of this paragraph (b)(2), paragraph (b)(3) of this section, and Sec. 1.1441-5 (c), (d), and (e) dealing with determinations of payee and applicable presumptions in the absence of documentation, apply only to payments of amounts subject to withholding under chapter 3 of the Code (within the meaning of Sec. 1.1441-2(a)). Similar payee and presumption provisions are set forth under Sec. 1.6049-5(d) for payments of amounts that are not subject to withholding under chapter 3 of the Code (or the regulations thereunder) but that may be reportable under provisions of chapter 61 of the Code (and the regulations thereunder). See paragraph (d) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a U.S. person. See paragraph (e) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a foreign person. For applicable presumptions of status in the absence of documentation, see paragraph (b)(3) of this section and Sec. 1.1441-5(d). For definitions of a foreign person and U.S. person, see paragraph (c)(2) of this section.

(ii) Payments to a U.S. agent of a foreign person.

A withholding agent making a payment to a U.S. person (other than to a U.S. branch that is treated as a U.S. person pursuant to paragraph (b)(2)(iv) of this section) and who has actual knowledge that the U.S. person receives the payment as an agent of a foreign person must treat the payment as made to the foreign person. However, the withholding agent may treat the payment as made to the U.S. person if the U.S. person is a financial institution and the withholding agent has no reason to believe that the financial institution will not comply with its obligation to withhold. See paragraph (c)(5) of this section for the definition of a financial institution.

(iii) Payments to wholly-owned entities

(A) Foreign-owned domestic entity.

A payment to a wholly-owned domestic entity that is disregarded for federal tax purposes under Sec. 301.7701-2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall be treated as a payment to the owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section. For purposes of this paragraph (b)(2)(iii)(A), a domestic entity means a person that would be treated as a U.S. person if it had an election in effect under Sec. 301.7701-3(c)(1)(i) of this chapter to be treated as a corporation. For example, a limited liability company, A, organized under the laws of the State of Delaware, opens an account at a U.S. bank. Upon opening of the account, the bank requests A to furnish a Form W-9 as required under section 6049(a) and the regulations under that section. A does not have an election in effect under Sec. 301.7701-3(c)(1)(i) of this chapter and, therefore, is not treated as an organization taxable as a corporation, including for purposes of the exempt recipient provisions in Sec. 1.6049-4(c)(1). If A has a single owner and the owner is a foreign person (as defined in paragraph (c)(2) of this section), then A may not furnish a Form W-9 because it may not represent that it is a U.S. person for purposes of the provisions of chapters 3 and 61 of the Code, and section 3406. Therefore, A must furnish a Form W-8 with the name, address, and taxpayer identifying number (TIN) (if required) of the foreign person who is the single owner in the same manner as if the account were opened directly by the foreign single owner. See Secs. 1.894-1T(d) and 1.1441-6(b)(2) for special rules where the entity's owner is claiming a reduced rate of withholding under an income tax treaty.

(B) Foreign entity.

A payment to a wholly-owned foreign entity that is disregarded under Sec. 301.7701-2(c)(2) of this chapter as an entity separate from its owner shall be treated as a payment to the single owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section if the foreign entity has a U.S. branch in the United States. For purposes of this paragraph (b)(2)(iii)(B), a foreign entity means a person that would be treated as a foreign person if it had an election in effect under Sec. 301.7701-3(c)(1)(i) of this chapter to be treated as a corporation. See Secs. 1.894-1T(d) and 1.1441-6(b)(2) for special rules where the foreign entity or its owner is claiming a reduced rate of withholding under an income tax treaty. Thus, for example, if the foreign entity's single

owner is a U.S. person, the payment shall be treated as a payment to a U.S. person. Therefore, based on the saving clause in U.S. income tax treaties, such an entity may not claim benefits under an income tax treaty even if the entity is organized in a country with which the United States has an income tax treaty in effect and treats the entity as a non-fiscally transparent entity. See Sec. 1.894-1T(d)(6), Example 10. Unless it has actual knowledge or reason to know that the foreign entity to whom the payment is made is disregarded under Sec. 301.7701-2(c)(2) of this chapter, a withholding agent may treat a foreign entity as an entity separate from its owner unless it can reliably associate the payment with a withholding certificate from the entity's owner.

(iv) Payments to a U.S. branch of certain foreign banks or foreign insurance companies.

(A) U.S. branch treated as a U.S. person in certain cases.

A payment to a U.S. branch of a foreign person is a payment to a foreign person. However, a U.S. branch described in this paragraph (b)(2)(iv)(A) and a withholding agent (including another U.S. branch described in this paragraph (b)(2)(iv)(A)) may agree to treat the branch as a U.S. person for purposes of withholding on specified payments to the U.S. branch. Notwithstanding the preceding sentence, a withholding agent making a payment to a U.S. branch treated as a U.S. person under this paragraph (b)(2)(iv)(A) shall not treat the branch as a U.S. person for purposes of reporting the payment made to the branch. Therefore, a payment to such U.S. branch shall be reported on Form 1042-S under Sec. 1.1461-1(c). Further, a U.S. branch that is treated as a U.S. person under this paragraph (b)(2)(iv)(A) shall not be treated as a U.S. person for purposes of the withholding certificate it may provide to a withholding agent. Therefore, the U.S. branch must furnish a U.S. branch withholding certificate on Form W-8 as provided in paragraph (e)(3)(v) of this section and not a Form W-9. An agreement to treat a U.S. branch as a U.S. person must be evidenced by a U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section furnished by the U.S. branch to the withholding agent. A U.S. branch described in this paragraph (b)(2)(iv)(A) is any U.S. branch of a foreign bank subject to regulatory supervision by the Federal Reserve Board or a U.S. branch of a foreign insurance company required to file an annual statement on a form approved by the National Association of Insurance Commissioners with the Insurance Department of a State, a Territory, or the District of Columbia. The Internal Revenue Service

(IRS) may approve a list of U.S. branches that may qualify for treatment as a U.S. person under this paragraph (b)(2)(iv)(A) (see Sec. 601.601(d)(2) of this chapter). See Sec. 1.6049-5(c)(5)(vi) for the treatment of U.S. branches as U.S. payors if they make a payment that is subject to reporting under chapter 61 of the Internal Revenue Code. Also see Sec. 1.6049-5(d)(1)(ii) for the treatment of U.S. branches as foreign payees under chapter 61 of the Internal Revenue Code.

(B) Consequences to the withholding agent.

Any person that is otherwise a withholding agent regarding a payment to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section shall treat the payment in one of the following ways--

(1) As a payment to a U.S. person, in which case the withholding agent is not responsible for withholding on such payment to the extent it can reliably associate the payment with a withholding certificate described in paragraph (e)(3)(v) of this section that has been furnished by the U.S. branch under its agreement with the withholding agent to be treated as a U.S. person;

(2) As a payment directly to the persons whose names are on withholding certificates or other appropriate documentation forwarded by the U.S. branch to the withholding agent when no agreement is in effect to treat the U.S. branch as a U.S. person for such payment, to the extent the withholding agent can reliably associate the payment with such certificates or documentation; or

(3) As a payment to a foreign person of income that is effectively connected with the conduct of a trade or business in the United States if the withholding agent cannot reliably associate the payment with a withholding certificate from the U.S. branch or any other certificate or other appropriate documentation from another person. See Sec. 1.1441-4(a)(2)(ii).

(C) Consequences to the U.S. branch.

A U.S. branch that is treated as a U.S. person under paragraph (b)(2)(iv)(A) of this section shall be treated as a separate person solely for purposes of section

1441(a) and all other provisions of chapter 3 of the Internal Revenue Code and the regulations thereunder (other than for purposes of reporting the payment to the U.S. branch under Sec. 1.1461-1(c) or for purposes of the documentation such a branch must furnish under paragraph (e)(3)(v) of this section) for any payment that it receives as such. Thus, the U.S. branch shall be responsible for withholding on the payment in accordance with the provisions under chapter 3 of the Internal Revenue Code and the regulations thereunder and other applicable withholding provisions of the Internal Revenue Code. For this purpose, it shall obtain and retain documentation from payees or beneficial owners of the payments that it receives as a U.S. person in the same manner as if it were a separate entity. For example, if a U.S. branch receives a payment on behalf of its home office and the home office is a qualified intermediary, the U.S. branch must obtain a qualified intermediary withholding certificate described in paragraph (e)(3)(ii) of this section from its home office. In addition, a U.S. branch that has not provided documentation to the withholding agent for a payment that is, in fact, not effectively connected income is a withholding agent with respect to that payment. See paragraph (b)(6) of this section and Sec. 1.1441-4(a)(2)(ii).

(D) Definition of payment to a U.S. branch.

A payment is treated as a payment to a U.S. branch of a foreign bank or foreign insurance company if the payment is credited to an account maintained in the United States in the name of a U.S. branch of the foreign person, or the payment is made to an address in the United States where the U.S. branch is located and the name of the U.S. branch appears on documents (in written or electronic form) associated with the payment (e.g., the check mailed or a letter addressed to the branch).

(E) Payments to other U.S. branches.

Similar withholding procedures may apply to payments to U.S. branches that are not described in paragraph (b)(2)(iv)(A) of this section to the extent permitted by the district director or the Assistant Commissioner (International). Any such branch must establish that its situation is analogous to that of a U.S. branch described in paragraph (b)(2)(iv)(A) of this section regarding its registration with, and regulation by, a U.S. governmental institution, the type and amounts of assets it is required to, or actually maintains in the United States, and

the personnel who carry out the activities of the branch in the United States. In the alternative, the branch must establish that the withholding and reporting requirements under chapter 3 of the Code and the regulations thereunder impose an undue administrative burden and that the collection of the tax imposed by section 871(a) or 881(a) on the foreign person (or its members in the case of a foreign partnership) will not be jeopardized by the exemption from withholding. Generally, an undue administrative burden will be found to exist in a case where the person entitled to the income, such as a foreign insurance company, receives from the withholding agent income on securities issued by a single corporation, some of which is, and some of which is not, effectively connected with conduct of a trade or business within the United States and the criteria for determining the effective connection are unduly difficult to apply because of the circumstances under which such securities are held. No exemption from withholding shall be granted under this paragraph (b)(2)(iv)(E) unless the person entitled to the income complies with such other requirements as may be imposed by the district director or the Assistant Commissioner (International) and unless the district director or the Assistant Commissioner (International) is satisfied that the collection of the tax on the income involved will not be jeopardized by the exemption from withholding. The IRS may prescribe such procedures as are necessary to make these determinations (see Sec. 601.601(d)(2) of this chapter).

(v) Payments to a foreign intermediary.

(A) Payments treated as made to persons for whom the intermediary collects the payment.

Except as otherwise provided in paragraph (b)(2)(v)(B) of this section, the payee of a payment to a person that the withholding agent may treat as a foreign intermediary in accordance with the provisions of paragraph (b)(3)(ii)(C) or (b)(3)(v)(A) of this section is the person or persons for whom the intermediary collects the payment. Thus, for example, the payee of a payment that the withholding agent can reliably associate with a withholding certificate from a qualified intermediary (defined in paragraph (e)(5)(ii) of this section) that does not assume primary withholding responsibility or a payment to a nonqualified intermediary are the persons for whom the qualified intermediary or nonqualified intermediary acts and not to the intermediary itself. See paragraph (b)(3)(v) of this section for presumptions that apply if the payment cannot be reliably

associated with valid documentation. For similar rules for payments to flow-through entities, see Sec. 1.1441-5(c)(1) and (e)(3).

(B) Payments treated as made to foreign intermediary.

he payee of a payment to a person that the withholding agent may treat as a qualified intermediary is the qualified intermediary to the extent that the qualified intermediary assumes primary withholding responsibility under paragraph (e)(5)(iv) of this section for the payment. For example if a qualified intermediary assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code but does not assume primary reporting or withholding responsibility under chapter 61 or section 3406 of the Internal Revenue Code and therefore provides Forms W-9 for U.S. non-exempt recipients, the qualified intermediary is the payee except to the extent the payment is reliably associated with a Form W-9 from a U.S. non-exempt recipient.

(vi) Other payees.

A payment to a person described in Sec. 1.6049-4(c)(1)(ii) that the withholding agent would treat as a payment to a foreign person without obtaining documentation for purposes of information reporting under section 6049 (if the payment were interest) is treated as a payment to a foreign payee for purposes of chapter 3 of the Code and the regulations thereunder (or to a foreign beneficial owner to the extent provided in paragraph (e)(1)(ii)(A) (6) or (7) of this section). Further, payments that the withholding agent can reliably associate with documentary evidence described in Sec. 1.6049-5(c)(1) relating to the payee is treated as a payment to a foreign payee. A payment that the withholding agent may treat as a payment to an authorized foreign agent (as defined in Sec. 1.1441-7(c)(2)) is treated as a payment to the agent and not to the persons for whom the agent collects the payment. See Sec. 1.1441-5 (b)(1) and (c)(1) for payee determinations for payments to partnerships. See Sec. 1.1441-5(e) for payee determinations for payments to foreign trusts or foreign estates.

(vii) Rules for reliably associating a payment with a withholding certificate or other appropriate documentation.

(A) Generally.

The presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d) apply to any payment, or portion of a

payment, that a withholding agent cannot reliably associate with valid documentation. Generally, a withholding agent can reliably associate a payment with valid documentation if, prior to the payment, it holds valid documentation (either directly or through an agent), it can reliably determine how much of the payment relates to the valid documentation, and it has no actual knowledge or reason to know that any of the information, certifications, or statements in, or associated with, the documentation are incorrect. Special rules apply for payments made to intermediaries, flow-through entities, and certain U.S. branches. See paragraph (b)(2)(vii)(B) through (F) of this section. The documentation referred to in this paragraph (b)(2)(vii) is documentation described in paragraphs (c)(16) and (17) of this section upon which a withholding agent may rely to treat the payment as a payment made to a payee or beneficial owner, and to ascertain the characteristics of the payee or beneficial owner that are relevant to withholding or reporting under chapter 3 of the Internal Revenue Code and the regulations thereunder. For purposes of this paragraph (b)(2)(vii), documentation also includes the agreement that the withholding agent has in effect with an authorized foreign agent in accordance with Sec. 1.1441-7(c)(2)(i). A withholding agent that is not required to obtain documentation with respect to a payment is considered to lack documentation for purposes of this paragraph (b)(2)(vii). For example, a withholding agent paying U.S. source interest to a person that is an exempt recipient, as defined in Sec. 1.6049-4(c)(1)(ii), is not required to obtain documentation from that person in order to determine whether an amount paid to that person is reportable under an applicable information reporting provision under chapter 61 of the Internal Revenue Code. The withholding agent must, however, treat the payment as made to an undocumented person for purposes of chapter 3 of the Internal Revenue Code. Therefore, the presumption rules of paragraph (b)(3)(iii) of this section apply to determine whether the person is presumed to be a U.S. person (in which case, no withholding is required under this section), or whether the person is presumed to be a foreign person (in which case 30-percent withholding is required under this section). See paragraph (b)(3)(v) of this section for special reliance rules in the case of a payment to a foreign intermediary and Sec. 1.1441-5(d) and (e)(6) for special reliance rules in the case of a payment to a flow-through entity.

(B) Special rules applicable to a withholding certificate from a nonqualified

intermediary or flow-through entity.

(1) In the case of a payment made to a nonqualified intermediary, a flow-through entity (as defined in paragraph (c)(23) of this section), and a U.S. branch described in paragraph (b)(2)(iv) of this section (other than a branch that is treated as a U.S. person), a withholding agent can reliably associate the payment with valid documentation only to the extent that, prior to the payment, the withholding agent can allocate the payment to a valid nonqualified intermediary, flow-through, or U.S. branch withholding certificate; the withholding agent can reliably determine how much of the payment relates to valid documentation provided by a payee as determined under paragraph (c)(12) of this section (i.e., a person that is not itself an intermediary, flow- through entity, or U.S. branch); and the withholding agent has sufficient information to report the payment on Form 1042-S or Form 1099, if reporting is required. See paragraph (e)(3)(iii) of this section for the requirements of a nonqualified intermediary withholding certificate, paragraph (e)(3)(v) of this section for the requirements of a U.S. branch certificate, and Secs. 1.1441-5(c)(3)(iii) and (e)(5)(iii) for the requirements of a flow-through withholding certificate. Thus, a payment cannot be reliably associated with valid documentation provided by a payee to the extent such documentation is lacking or unreliable, or to the extent that information required to allocate and report all or a portion of the payment to each payee is lacking or unreliable. If a withholding certificate attached to an intermediary, U.S. branch, or flow-through withholding certificate is another intermediary, U.S. branch, or flow-through withholding certificate, the rules of this paragraph (b)(2)(vii)(B) apply by treating the share of the payment allocable to the other intermediary, U.S. branch, or flow-through entity as if the payment were made directly to such other entity. See paragraph (e)(3)(iv)(D) of this section for rules permitting information allocating a payment to documentation to be received after the payment is made.

(2) The rules of paragraph (b)(2)(vii)(B)(1) of this section are illustrated by the following examples:

Example 1. WH, a withholding agent, makes a payment of U.S. source

interest to NQI, an intermediary that is a nonqualified intermediary. NQI provides a valid intermediary withholding certificate under paragraph (e)(3)(iii) of this section. NQI does not, however, provide valid documentation from the persons on whose behalf it receives the interest payment, and, therefore, the interest payment cannot be reliably associated with valid documentation provided by a payee. WH must apply the presumption rules of paragraph (b)(3)(v) of this section to the payment.

Example 2. The facts are the same as in Example 1, except that NQI does attach valid beneficial owner withholding certificates (as defined in paragraph (e)(2)(i) of this section) from A, B, C, and D establishing their status as foreign persons. NQI does not, however, provide WH with any information allocating the payment among A, B, C, and D and, therefore, WH cannot determine the portion of the payment that relates to each beneficial owner withholding certificate. The interest payment cannot be reliably associated with valid documentation from a payee and WH must apply the presumption rules of paragraph (b)(3)(v) of this section to the payment. See, however, paragraph (e)(3)(iv)(D) of this section providing special rules permitting allocation information to be received after a payment is made.

Example 3. The facts are the same as in Example 2, except that NQI does provide allocation information associated with its intermediary withholding certificate indicating that 25 percent of the interest payment is allocable to A and 25 percent to B. NQI does not provide any allocation information regarding the remaining 50 percent of the payment. WH may treat 25 percent of the payment as made to A and 25 percent as made to B. The remaining 50 percent of the payment cannot be reliably associated with valid documentation from a payee, however, since NQI did not provide information allocating the payment. Thus, the remaining 50 percent of the payment is subject to the presumption rules of paragraph (b)(3)(v) of this section.

Example 4. WH makes a payment of U.S. source interest to NQI1, an intermediary that is not a qualified intermediary. NQI1 provides WH with a valid nonqualified intermediary withholding certificate as well a valid beneficial owner withholding certificates from A and B and a valid

nonqualified intermediary withholding certificate from NQI2. NQI2 has provided valid beneficial owner documentation from C sufficient to establish C's status as a foreign person. Based on information provided by NQI1, WH can allocate 20 percent of the interest payment to A, and 20 percent to B. Based on information that NQI2 provided NQI1 and that NQI1 provides to WH, WH can allocate 60 percent of the payment to NQI 2, but can only allocate one half of that payment (30 percent) to C. Therefore, WH cannot reliably associate 30 percent of the payment made to NQI2 with valid documentation and must apply the presumption rules of paragraph (b)(3)(v) of this section to that portion of the payment.

(C) Special rules applicable to a withholding certificate provided by a qualified intermediary that does not assume primary withholding responsibility.

(1) If a payment is made to a qualified intermediary that does not assume primary withholding responsibility under chapter 3 of the Internal Revenue Code or primary Form 1099 reporting and backup withholding responsibility under chapter 61 and section 3406 of the Internal Revenue Code for the payment, a withholding agent can reliably associate the payment with valid documentation only to the extent that, prior to the payment, the withholding agent has received a valid qualified intermediary withholding certificate and the withholding agent can reliably determine the portion of the payment that relates to a withholding rate pool, as defined in paragraph (e)(5)(v)(C) of this section. In the case of a withholding rate pool attributable to a U.S. non-exempt recipient, a payment cannot be reliably associated with valid documentation unless, prior to the payment, the qualified intermediary has provided the U.S. person's Form W-9 (or, in the absence of the form, the name, address, and TIN, if available, of the U.S. person) and sufficient information for the withholding agent to report the payment on Form 1099. See paragraph (e)(5)(v)(C)(2) of this section for special rules regarding allocation of payments among U.S. non-exempt recipients.

(2) The rules of this paragraph (b)(2)(vii)(C) are illustrated by the following examples:

Example 1. WH, a withholding agent, makes a payment of U.S. source dividends to QI. QI provides WH with a valid qualified intermediary withholding certificate on which it indicates that it does not assume primary withholding responsibility under chapter 3 of the Internal Revenue Code or primary Form 1099 reporting and backup withholding responsibility under chapter 61 and section 3406 of the Internal Revenue Code. QI does not provide any information allocating the dividend to withholding rate pools. WH cannot reliably associate the payment with valid payee documentation and therefore must apply the presumption rules of paragraph (b)(3)(v) of this section.

Example 2. WH makes a payment of U.S. source dividends to QI. QI has 5 customers: A, B, C, D, and E. QI has obtained documentation from A and B establishing their entitlement to a 15 percent rate of tax on U.S. source dividends under an income tax treaty. C is a U.S. person that is an exempt recipient as defined in paragraph (c)(20) of this section. D and E are U.S. non-exempt recipients who have provided Forms W-9 to QI. A, B, C, D, and E are each entitled to 20 percent of the dividend payment. QI provides WH with a valid qualified intermediary withholding certificate as described in paragraph (e)(2)(ii) of this section with which it associates the Forms W-9 from D and E. QI associates the following allocation information with its qualified intermediary withholding certificate: 40 percent of the payment is allocable to the 15 percent withholding rate pool, and 20 percent is allocable to each of D and E. QI does not provide any allocation information regarding the remaining 20 percent of the payment. WH cannot reliably associate 20 percent of the payment with valid documentation and, therefore, must apply the presumption rules of paragraph (b)(3)(v) of this section to that portion of the payment. The 20 percent of the payment allocable to the 15 percent withholding rate pool, and the portion of the payments allocable to D and E are payments that can be reliably associated with documentation.

(D) Special rules applicable to a withholding certificate provided by a qualified intermediary that assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code.

(1) In the case of a payment made to a qualified intermediary that

assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code with respect to that payment (but does not assume primary Form 1099 reporting and backup withholding responsibility under chapter 61 and section 3406 of the Internal Revenue Code), a withholding agent can reliably associate the payment with valid documentation only to the extent that, prior to the payment, the withholding agent has received a valid qualified intermediary withholding certificate and the withholding agent can reliably determine the portion of the payment that relates to the withholding rate pool for which the qualified intermediary assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code and the portion of the payment attributable to withholding rate pools for each U.S. non-exempt recipient for whom the qualified intermediary has provided a Form W-9 (or, in absence of the form, the name, address, and TIN, if available, of the U.S. non-exempt recipient). See paragraph (e)(5)(v)(C)(2) of this section for alternative allocation procedures for payments made to U.S. persons that are not exempt recipients.

(2) Examples. The following examples illustrate the rules of paragraph (b)(2)(vii)(D)(1) of this section:

Example 1. WH makes a payment of U.S. source interest to QI, a qualified intermediary. QI provides WH with a withholding certificate that indicates that QI will assume primary withholding responsibility under chapter 3 of the Internal Revenue Code with respect to the payment. In addition, QI attaches a Form W-9 from A, a U.S. non-exempt recipient, as defined in paragraph (c)(21) of this section, and provides the name, address, and TIN of B, a U.S. person that is also a non-exempt recipient but who has not provided a Form W-9. QI associates a withholding statement with its qualified intermediary withholding certificate indicating that 10 percent of the payment is attributable to A, and 10 percent to B, and that QI will assume primary withholding responsibility with respect to the remaining 80 percent of the payment. WH can reliably associate the entire payment with valid documentation. Although under the presumption rule of paragraph (b)(3)(v) of this section, an undocumented person receiving U.S. source interest is generally presumed to be a foreign person, WH has actual

knowledge that B is a U.S. non-exempt recipient and therefore must report the payment on Form 1099 and backup withhold on the interest payment under section 3406.

Example 2. The facts are the same as in Example 1, except that no Forms W-9 or other information have been provided for the 20 percent of the payment that is allocable to A and B. Thus, QI has accepted withholding responsibility for 80 percent of the payment, but has provided no information for the remaining 20 percent. In this case, 20 percent of the payment cannot be reliably associated with valid documentation, and WH must apply the presumption rule of paragraph (b)(3)(v) of this section.

(E) Special rules applicable to a withholding certificate provided by a qualified intermediary that assumes primary Form 1099 reporting and backup withholding responsibility but not primary withholding under chapter 3.

(1) If a payment is made to a qualified intermediary that assumes primary Form 1099 reporting and backup withholding responsibility for the payment (but does not assume primary withholding responsibility under chapter 3 of the Internal Revenue Code), a withholding agent can reliably associate the payment with valid documentation only to the extent that, prior to the payment, the withholding agent has received a valid qualified intermediary withholding certificate and the withholding agent can reliably determine the portion of the payment that relates to a withholding rate pool or pools provided as part of the qualified intermediary's withholding statement and the portion of the payment for which the qualified intermediary assumes primary Form 1099 reporting and backup withholding responsibility.

(2) The following example illustrates the rules of paragraph (b)(2)((vii)(D)(1) of this section:

Example. WH makes a payment of U.S. source dividends to QI, a qualified intermediary. QI has provided WH with a valid qualified intermediary withholding certificate. QI states on its withholding statement accompanying the certificate that it assumes primary Form 1099 reporting and backup withholding responsibility but does not

assume primary withholding responsibility under chapter 3 of the Internal Revenue Code. QI represents that 15 percent of the dividend is subject to a 30 percent rate of withholding, 75 percent of the dividend is subject to a 15 percent rate of withholding, and that QI assumed primary Form 1099 reporting and backup withholding for the remaining 10 percent of the payment. The entire payment can be reliably associated with valid documentation.

(F) Special rules applicable to a withholding certificate provided by a qualified intermediary that assumes primary withholding responsibility under chapter 3 and primary Form 1099 reporting and backup withholding responsibility and a withholding certificate provided by a withholding foreign partnership. If a payment is made to a qualified intermediary that assumes both primary withholding responsibility under chapter 3 of the Internal Revenue Code and primary Form 1099 reporting and backup withholding responsibility under chapter 61 and section 3406 of the Internal Revenue Code for the payment, a withholding agent can reliably associate a payment with valid documentation provided that it receives a valid qualified intermediary withholding certificate as described in paragraph (e)(3)(ii) of this section. In the case of a payment made to a withholding foreign partnership, the withholding agent can reliably associate the payment with valid documentation to the extent it can associate the payment with a valid withholding certificate described in Sec. 1.1441- 5(c)(2)(iv).

(3) Presumptions regarding payee's status in the absence of documentation.

(i) General rules.

A withholding agent that cannot, prior to the payment, reliably associate (within the meaning of paragraph (b)(2)(vii) of this section) a payment of an amount subject to withholding (as described in Sec. 1.1441-2(a)) with valid documentation may rely on the presumptions of this paragraph (b)(3) to determine the status of the payee as a U.S. or a foreign person and the payee's other relevant characteristics (e.g., as an owner or intermediary, as an individual, trust, partnership, or corporation). The determination of withholding and reporting requirements applicable to payments to a person presumed to be a foreign person is governed only by the provisions of chapter 3 of the Code and the regulations thereunder. For the determination of withholding and reporting requirements applicable to payments to a person presumed to be a U.S. person, see chapter 61 of the Code, section 3402, 3405, or 3406, and the regulations under these provisions. A

presumption that a payee is a foreign payee is not a presumption that the payee is a foreign beneficial owner. Therefore, the provisions of this paragraph (b)(3) have no effect for purposes of reducing the withholding rate if associating the payment with documentation of foreign beneficial ownership is required as a condition for such rate reduction. See paragraph (b)(3)(ix) of this section for consequences to a withholding agent that fails to withhold in accordance with the presumptions set forth in this paragraph (b)(3) or if the withholding agent has actual knowledge or reason to know of facts that are contrary to the presumptions set forth in this paragraph (b)(3). See paragraph (b)(2)(vii) of this section for rules regarding the extent which a withholding agent can reliably associate a payment with documentation.

(ii) Presumptions of classification as individual, corporation, partnership, etc.

(A) In general.

A withholding agent that cannot reliably associate a payment with a valid withholding certificate or that has received valid documentary evidence under Secs. 1.1441- 1(e)(1)(ii)(2) and 1.6049-5(c)(1) or (4) but cannot determine a payee's classification from the documentary evidence must apply the rules of this paragraph (b)(3)(ii) to determine the payee's classification as an individual, trust, estate, corporation, or partnership. The fact that a payee is presumed to have a certain status under the provisions of this paragraph (b)(3)(ii) does not mean that it is excused from furnishing documentation if documentation is otherwise required to obtain a reduced rate of withholding under this section. For example, if, for purposes of this paragraph (b)(3)(ii), a payee is presumed to be a tax- exempt organization based on Sec. 1.6049-4(c)(1)(ii)(B), the withholding agent cannot rely on this presumption to reduce the rate of withholding on payments to such person (if such person is also presumed to be a foreign person under paragraph (b)(3)(iii)(A) of this section) because a reduction in the rate of withholding for payments to a foreign tax-exempt organization generally requires that a valid Form W- 8 described in Sec. 1.1441-9(b)(2) be furnished to the withholding agent.

(B) No documentation provided.

If the withholding agent cannot reliably associate a payment with a valid withholding certificate or valid documentary evidence, it must presume that the payee is an individual, a trust, or an estate, if the payee appears to be such

person (e.g., based on the payee's name or other indications). In the absence of reliable indications that the payee is an individual, trust, or an estate, the withholding agent must presume that the payee is a corporation or one of the persons enumerated under Sec. 1.6049- 4(c)(1)(ii)(B) through (Q) if it can be so treated under Sec. 1.6049- 4(c)(1)(ii)(A)(1) or any one of the paragraphs under Sec. 1.6049- 4(c)(1)(ii)(B) through (Q) without the need to furnish documentation. If the withholding agent cannot treat a payee as a person described in Sec. 1.6049-4(c)(1)(ii)(A)(1) through (Q), then the payee shall be presumed to be a partnership. If such a partnership is presumed to be foreign, it is not the beneficial owner of the income paid to it. See paragraph (c)(6) of this section. If such a partnership is presumed to be domestic, it is a U.S. non-exempt recipient for purposes of chapter 61 of the Internal Revenue Code.

(C) Documentary evidence furnished for offshore account.

If the withholding agent receives valid documentary evidence, as described in Sec. 1.6049-5(c)(1) or (4), with respect to an offshore account from an entity but the documentary evidence does not establish the entity's classification as a corporation, trust, estate, or partnership, the withholding agent may presume (in the absence of actual knowledge otherwise) that the entity is the type of person enumerated under Sec. 1.6049-4 (c)(1)(ii)(B) through (Q) if it can be so treated under any one of those paragraphs without the need to furnish documentation. If the withholding agent cannot treat a payee as a person described in Sec. 1.6049-4(c)(1)(ii)(B) through (Q), then the payee shall be presumed to be a corporation unless the withholding agent knows, or has reason to know, that the entity is not classified as a corporation for U.S. tax purposes. If a payee is, or is presumed to be, a corporation under this paragraph (b)(3)(ii)(C) and a foreign person under paragraph (b)(3)(iii) of this section, a withholding agent shall not treat the payee as the beneficial owner of income if the withholding agent knows, or has reason to know, that the payee is not the beneficial owner of the income. For this purpose, a withholding agent shall have reason to know that the payee is not a beneficial owner if the documentary evidence indicates that the payee is a bank, broker, intermediary, custodian, or other agent, or is treated under Sec. 1.6049- 4(c)(1)(ii)(B) through (Q) as such a person. A withholding agent may, however, treat such a person as a beneficial owner if the foreign person provides a statement, in writing and signed by a person with authority to sign the statement, that is

attached to the documentary evidence stating it is the beneficial owner of the income.

(iii) Presumption of U.S. or foreign status.

A payment that the withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person, except as otherwise provided in this paragraph (b)(3)(iii), in paragraphs (b)(3) (iv) and (v) of this section, or in Sec. 1.1441-5 (d) or (e).

(A) Payments to exempt recipients.

If a withholding agent cannot reliably associate a payment with documentation from the payee and the payee is an exempt recipient (as determined under the provisions of Sec. 1.6049-4(c)(1)(ii) in the case of interest, or under similar provisions under chapter 61 of the Code applicable to the type of payment involved, but not including a payee that the withholding agent may treat as a foreign intermediary in accordance with paragraph (b)(3)(v) of this section), the payee is presumed to be a foreign person and not a U.S. person--

(1) If the withholding agent has actual knowledge of the payee's employer identification number and that number begins with the two digits ``98";

(2) If the withholding agent's communications with the payee are mailed to an address in a foreign country;

(3) If the name of the payee indicates that the entity is the type of entity that is on the per se list of foreign corporations contained in Sec. 301.7701-2(b)(8)(i) of this chapter; or

(4) If the payment is made outside the United States (as defined in Sec. 1.6049-5(e)).

(B) Scholarships and grants.

A payment representing taxable scholarship or fellowship grant income that does not represent compensation for services (but is not excluded from tax under section 117) and that a withholding agent cannot reliably associate with documentation is presumed to be made to a foreign person if the withholding agent has a record that the payee has a U.S. visa that is not an immigrant visa.

See section 871(c) and Sec. 1.1441-4(c) for applicable tax rate and withholding rules.

(C) Pensions, annuities, etc.

A payment from a trust described in section 401(a), an annuity plan described in section 403(a), a payment with respect to any annuity, custodial account, or retirement income account described in section 403(b), or a payment from an individual retirement account or individual retirement annuity described in section 408 that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person only if the withholding agent has a record of a Social Security number for the payee and relies on a mailing address described in the following sentence. A mailing address is an address used for purposes of information reporting or otherwise communicating with the payee that is an address in the United States or in a foreign country with which the United States has an income tax treaty in effect and the treaty provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts described in this paragraph (b)(3)(iii)(C). Any payment described in this paragraph (b)(3)(iii)(C) that is not presumed to be made to a U.S. person is presumed to be made to a foreign person. A withholding agent making a payment to a person presumed to be a foreign person may not reduce the 30-percent amount of withholding required on such payment unless it receives a withholding certificate described in paragraph (e)(2)(i) of this section furnished by the beneficial owner. For reduction in the 30-percent rate, see Secs. 1.1441-4(e) or 1.1441-6(b).

(D) Certain payments to offshore accounts.

A payment is presumed made to a foreign payee if the payment is made outside the United States (as defined in Sec. 1.6049-5(e)) to an offshore account (as defined in Sec. 1.6049-5(c)(1)) and the withholding agent does not have actual knowledge that the payee is a U.S. person. See Sec. 1.6049- 5(d)(2) and (3) for exceptions to this rule.

(iv) Grace period.

A withholding agent may choose to apply the provisions of Sec. 1.6049-5(d)(2)(ii) regarding a 90-day grace period for purposes of this paragraph (b)(3) (by applying the term withholding agent instead of the term payor) to amounts described in Sec. 1.1441-

6(c)(2) and to amounts covered by a Form 8233 described in Sec. 1.1441- 4(b)(2)(ii). Thus, for these amounts, a withholding agent may choose to treat an account holder as a foreign person and withhold under chapter 3 of the Internal Revenue Code (and the regulations thereunder) while awaiting documentation. For purposes of determining the rate of withholding under this section, the withholding agent must withhold at the unreduced 30-percent rate at the time that the amounts are credited to an account. However, a withholding agent who can reliably associate the payment with a withholding certificate that is otherwise valid within the meaning of the applicable provisions except for the fact that it is transmitted by facsimile may rely on that facsimile form for purposes of withholding at the claimed reduced rate. For reporting of amounts credited both before and after the grace period, see Sec. 1.1461-1(c)(4)(i)(A). The following adjustments shall be made at the expiration of the grace period:

(A) If, at the end of the grace period, the documentation is not furnished in the manner required under this section and the account holder is presumed to be a U.S. non-exempt recipient, then backup withholding applies to amounts credited to the account after the expiration of the grace period only. Amounts credited to the account during the grace period shall be treated as owned by a foreign payee and adjustments must be made to correct any underwithholding on such amounts in the manner described in Sec. 1.1461-2.

(B) If, at the end of the grace period, the documentation is not furnished in the manner required under this section, or if documentation is furnished that does not support the claimed rate reduction, and the account holder is presumed to be a foreign person then adjustments must be made to correct any underwithholding on amounts credited to the account during the grace period, based on the adjustment procedures described in Sec. 1.1461-2.

(v) Special rules applicable to payments to foreign intermediaries.

(A) Reliance on claim of status as foreign intermediary.

The presumption rules of paragraph (b)(3)(v)(B) of this section apply to a payment made to an intermediary (whether the intermediary is a qualified or nonqualified intermediary) that has provided a valid withholding certificate under paragraph (e)(3)(ii) or (iii) of this section (or has provided documentary evidence described in paragraph (b)(3)(ii)(C) of this section that indicates it is a bank, broker, custodian, intermediary, or other agent) to the extent the

withholding agent cannot treat the payment as being reliably associated with valid documentation under the rules of paragraph (b)(2)(vii) of this section. For this purpose, a U.S. person's foreign branch that is a qualified intermediary defined in paragraph (e)(5)(ii) of this section shall be treated as a foreign intermediary. A payee that the withholding agent may not reliably treat as a foreign intermediary under this paragraph (b)(3)(v)(A) is presumed to be a payee other than an intermediary whose classification as an individual, corporation, partnership, etc., must be determined in accordance with paragraph (b)(3)(ii) of this section to the extent relevant. In addition, such payee is presumed to be a U.S. or a foreign payee based upon the presumptions described in paragraph (b)(3)(iii) of this section. The provisions of paragraph (b)(3)(v)(B) of this section are not relevant to a withholding agent that can reliably associate a payment with a withholding certificate from a person representing to be a qualified intermediary to the extent the qualified intermediary has assumed primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section.

(B) Beneficial owner documentation or allocation information is lacking or unreliable.

Any portion of a payment that the withholding agent may treat as made to a foreign intermediary (whether a nonqualified or a qualified intermediary) but that the withholding agent cannot treat as reliably associated with valid documentation under the rules of paragraph (b)(2)(vii) of this section is presumed made to an unknown, undocumented foreign payee. As a result, a withholding agent must deduct and withhold 30 percent from any payment of an amount subject to withholding. If a withholding certificate attached to an intermediary certificate is another intermediary withholding certificate or a flow-through withholding certificate, the rules of this paragraph (b)(3)(v)(B) (or Sec. 1.1441-5(d)(3) or (e)(6)(iii)) apply by treating the share of the payment allocable to the other intermediary or flow-through entity as if it were made directly to the other intermediary or flow-through entity. Any payment of an amount subject to withholding that is presumed made to an undocumented foreign person must be reported on Form 1042-S. See Sec. 1.1461-1(c). See Sec. 1.6049-5(d) for payments that are not subject to withholding.

(vi) U.S. branches. The rules of paragraph (b)(3)(v)(B) of this section shall apply to payments to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that has

provided a withholding certificate as described in paragraph (e)(3)(v) of this section on which it has not agreed to be treated as a U.S. person.

(vii) Joint payees.

(A) In general.

Except as provided in paragraph (b)(3)(vii)(B) of this section, if a withholding agent makes a payment to joint payees and cannot reliably associate a payment with valid documentation from all payees, the payment is presumed made to an unidentified U.S. person. However, if one of the joint payees provides a Form W-9 furnished in accordance with the procedures described in Secs. 31.3406(d)-1 through 31.3406(d)-5 of this chapter, the payment shall be treated as made to that payee. See Sec. 31.3406(h)-2 of this chapter for rules to determine the relevant payee if more than one Form W-9 is provided. For purposes of applying this paragraph (b)(3), the grace period rules in paragraph (b)(3)(iv) of this section shall apply only if each payee meets the conditions described in paragraph (b)(3)(iv) of this section.

(B) Special rule for offshore accounts.

If a withholding agent makes a payment to joint payees and cannot reliably associate a payment with valid documentation from all payees, the payment is presumed made to an unknown foreign payee if the payment is made outside the United States (as defined in Sec. 1.6049-5(e)) to an offshore account (as defined in Sec. 1.6049-5(c)(1)).

(viii) Rebuttal of presumptions.

A payee or beneficial owner may rebut the presumptions described in this paragraph (b)(3) by providing reliable documentation to the withholding agent or, if applicable, to the IRS.

(ix) Effect of reliance on presumptions and of actual knowledge or reason to know otherwise.

(A) General rule.

Except as otherwise provided in paragraph (b)(3)(ix)(B) of this section, a withholding agent that withholds on a payment under section 3402, 3405 or 3406 in accordance with the presumptions set forth in this paragraph (b)(3)

shall not be liable for withholding under this section even it is later established that the beneficial owner of the payment is, in fact, a foreign person. Similarly, a withholding agent that withholds on a payment under this section in accordance with the presumptions set forth in this paragraph (b)(3) shall not be liable for withholding under section 3402 or 3405 or for backup withholding under section 3406 even if it is later established that the payee or beneficial owner is, in fact, a U.S. person. A withholding agent that, instead of relying on the presumptions described in this paragraph (b)(3), relies on its own actual knowledge to withhold a lesser amount, not withhold, or not report a payment, even though reporting of the payment or withholding a greater amount would be required if the withholding agent relied on the presumptions described in this paragraph (b)(3) shall be liable for tax, interest, and penalties to the extent provided under section 1461 and the regulations under that section. See paragraph (b)(7) of this section for provisions regarding such liability if the withholding agent fails to withhold in accordance with the presumptions described in this paragraph (b)(3).

(B) Actual knowledge or reason to know that amount of withholding is greater than is required under the presumptions or that reporting of the payment is required.

Notwithstanding the provisions of paragraph (b)(3)(ix)(A) of this section, a withholding agent may not rely on the presumptions described in this paragraph (b)(3) to the extent it has actual knowledge or reason to know that the status or characteristics of the payee or of the beneficial owner are other than what is presumed under this paragraph (b)(3) and, if based on such knowledge or reason to know, it should withhold (under this section or another withholding provision of the Code) an amount greater than would be the case if it relied on the presumptions described in this paragraph (b)(3) or it should report (under this section or under another provision of the Code) an amount that would not otherwise be reportable if it relied on the presumptions described in this paragraph (b)(3). In such a case, the withholding agent must rely on its actual knowledge or reason to know rather than on the presumptions set forth in this paragraph (b)(3). Failure to do so and, as a result, failure to withhold the higher amount or to report the payment, shall result in liability for tax, interest, and penalties to the extent provided under sections 1461 and 1463 and the regulations under those sections.

(x) Examples.

The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. A withholding agent, W, makes a payment of U.S. source dividends to person X, Inc. at an address outside the United States. W cannot reliably associate the payment to X with documentation. Under Secs. 1.6042-3(b)(1)(vii) and 1.6049-4(c)(1)(ii)(A)(1), W may treat X as a corporation. Thus, under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that X is a foreign person (because the payment is made outside the United States). However, W knows that X is a U.S. person who is an exempt recipient. W may not rely on its actual knowledge to not withhold under this section. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 1461. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that the tax is not due or has been satisfied. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 1461 for the amount that W should have withheld based upon the presumptions. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that its actual knowledge was, in fact, correct and that no tax or a lesser amount of tax was due.

Example 2. A withholding agent, W, makes a payment of U.S. source dividends to Y who does not qualify as an exempt recipient under Secs. 1.6042-3(b)(1)(vii) and 1.6049-4(c)(1)(ii). W cannot reliably associate the payment to Y with documentation. Under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that Y is a U.S. person who is not an exempt recipient for purposes of section 6042. However, W knows that Y is a foreign person. W may not rely on its actual knowledge to withhold under this section rather than backup withhold under section 3406. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 3403. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 3403 for the amount that W should have withheld based upon the presumptions. Paragraph (b)(7) of this section does not apply to provide relief from liability under section 3403.

Example 3. A withholding agent, W, makes a payment of U.S. source dividends to X, Inc. W cannot reliably associate the payment to X, Inc. with documentation. X, Inc. presents none of the indicia of foreign status described in paragraph (b)(3)(iii)(A) of this

section, but W has actual knowledge that X, Inc. is a foreign corporation. W may treat X, Inc. as an exempt recipient under Sec. 1.6042-3(b)(1)(vii). Because there are no indicia of foreign status, W would, absent actual knowledge or reason to know otherwise, be permitted to treat X, Inc. as a domestic corporation in accordance with the presumptions of paragraph (b)(3)(iii) of this section. However, under paragraph (b)(3)(ix)(B) of this section, W may not rely on the presumption of U.S. status since reliance on its actual knowledge requires that it withhold an amount greater than would be the case under the presumptions.

Example 4. A withholding agent, W, is a plan administrator who makes pension payments to person X with a mailing address in a foreign country with which the United States has an income tax treaty in effect. Under that treaty, the type of pension income paid to X is taxable solely in the country of residence. The plan administrator has a record of X's U.S. social security number. W has no actual knowledge or reason to know that X is a foreign person. W may rely on the presumption of paragraph (b)(3)(iii)(C) of this section in order to treat X as a U.S. person. Therefore, any withholding and reporting requirements for the payment are governed by the provisions of section 3405 and the regulations under that section.

(4) List of exemptions from, or reduced rates of, withholding under chapter 3 of the Code.

A withholding agent that has determined that the payee is a foreign person for purposes of paragraph (b)(1) of this section must determine whether the payee is entitled to a reduced rate of withholding under section 1441, 1442, or 1443. This paragraph (b)(4) identifies items for which a reduction in the rate of withholding may apply and whether the rate reduction is conditioned upon documentation being furnished to the withholding agent. Documentation required under this paragraph (b)(4) is documentation that a withholding agent must be able to associate with a payment upon which it can rely to treat the payment as made to a foreign person that is the beneficial owner of the payment in accordance with paragraph (e)(1)(ii) of this section. This paragraph (b)(4) also cross-references other sections of the Code and applicable regulations in which some of these exceptions, exemptions, or reductions are further explained. See, for example, paragraph (b)(4)(viii) of this section, dealing with effectively connected income, that cross-references Sec. 1.1441-4(a); see paragraph (b)(4)(xv) of this section, dealing with exemptions from, or reductions of, withholding under an income tax treaty, that cross-references Sec. 1.1441-6. This paragraph (b)(4) is not an exclusive list of items to which a reduction of the rate of withholding may apply and, thus, does not preclude an exemption from, or reduction in, the rate of withholding that may otherwise be allowed under the regulations under the provisions of chapter 3 of the Code for a particular item of income

identified in this paragraph (b)(4).

(i) Portfolio interest described in section 871(h) or 881(c) and substitute interest payments described in Sec. 1.871-7(b)(2) or 1.881-2(b)(2) are exempt from withholding under section 1441(a). See Sec. 1.871-14 for regulations regarding portfolio interest and section 1441(c)(9) for exemption from withholding. Documentation establishing foreign status is required for interest on an obligation in registered form to qualify as portfolio interest. See section 871(h)(2)(B)(ii) and Sec. 1.871-14(c)(1)(ii)(C). For special documentation rules regarding foreign-targeted registered obligations described in Sec. 1.871-14(e)(2), see Sec. 1.871-14(e) (3) and (4) and, in particular, Sec. 1.871-14(e)(4)(i)(A) and (ii)(A) regarding the time when the withholding agent must receive the documentation. The documentation furnished for purposes of qualifying interest as portfolio interest serves as the basis for the withholding exemption for purposes of this section and for purposes of establishing foreign status for purposes of section 6049. See Sec. 1.6049-5(b)(8). Documentation establishing foreign status is not required for qualifying interest on an obligation in bearer form described in Sec. 1.871-14(b)(1) as portfolio interest. However, in certain cases, documentation for portfolio interest on a bearer obligation may have to be furnished in order to establish foreign status for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See Sec. 1.6049-5(b)(7).

(ii) Bank deposit interest and similar types of deposit interest (including original issue discount) described in section 871(i)(2)(A) or 881(d) that are from sources within the United States are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See Sec. 1.6049-5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also Sec. 1.6049-5(b)(11) for applicable documentation exemptions for certain bank deposit interest paid on obligations in bearer form.

(iii) Bank deposit interest (including original issue discount) described in section 861(a)(1)(B) is exempt from withholding under sections 1441(a) as income that is not from U.S. sources. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. Reporting requirements for payments of such interest are governed by section

6049 and the regulations under that section. See Sec. 1.6049-5(b)(12) and alternative documentation rules under Sec. 1.6049-5(c)(1).

(iv) Interest or original issue discount from sources within the United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3) is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See Sec. 1.6049-5(b)(12) for applicable documentation for establishing foreign status and Sec. 1.6049-5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also Sec. 1.6049-5(b)(10) for applicable documentation exemptions for certain obligations in bearer form.

(v) Income from sources without the United States is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 or other applicable provisions of chapter 61 of the Code and backup withholding under section 3406. See, for example, Sec. 1.6049-5(b) (6) and (12) and alternative documentation rules under Sec. 1.6049-5(c). See also paragraph (b)(5) of this section for cross references to other applicable provisions of the regulations under chapter 61 of the Code.

(vi) Distributions from certain domestic corporations described in section 871(i)(2)(B) or 881(d) are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section 3406. See Sec. 1.6042-3(b)(1) (iii) through (vi).

(vii) Dividends paid by certain foreign corporations that are treated as income from sources within the United States by reason of section 861(a)(2)(B) are exempt from withholding under section 884(e)(3) to the extent that the distributions are paid out of earnings and profits in any taxable year that the corporation was subject to branch profits tax for that year. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section

3406. See Sec. 1.6042-3(b)(1) (iii) through (vii).

(viii) Certain income that is effectively connected with the conduct of a U.S. trade or business is exempt from withholding under section 1441(a). See section 1441(c)(1). Documentation establishing foreign status and status of the income as effectively connected must be furnished for purposes of this withholding exemption to the extent required under the provisions of Sec. 1.1441-4(a). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, Sec. 1.6041-4(a)(1).

(ix) Certain income with respect to compensation for personal services of an individual that are performed in the United States is exempt from withholding under section 1441(a). See section 1441(c)(4) and Sec. 1.1441-4(b). However, such income may be subject to withholding as wages under section 3402. Documentation establishing foreign status must be furnished for purposes of any withholding exemption or reduction to the extent required under Sec. 1.1441-4(b) or 31.3401(a)(6)-1 (e) and (f) of this chapter. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See Sec. 1.6041-4(a)(1).

(x) Amounts described in section 871(f) that are received as annuities from certain qualified plans are exempt from withholding under section 1441(a). See section 1441(c)(7). Documentation establishing foreign status must be furnished for purposes of the withholding exemption as required under Sec. 1.1441-4(d). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See Sec. 1.6041-4(a)(1).

(xi) Payments to a foreign government (including a foreign central bank of issue) that are excludable from gross income under section 892(a) are exempt from withholding under section 1442. See Sec. 1.1441-8(b). Documentation establishing status as a foreign government is required for purposes of this withholding exemption. Payments to a foreign government are exempt from information reporting under chapter 61 of the Code (see Sec. 1.6049-4(c)(1)(ii)(F)).

(xii) Payments of certain interest income to a foreign central bank of issue or the Bank for International Settlements that are exempt from tax under section 895 are exempt from withholding under section 1442. Documentation establishing eligibility for such

exemption is required to the extent provided in Sec. 1.1441-8(c)(1). Payments to a foreign central bank of issue or to the Bank for International Settlements are exempt from information reporting under chapter 61 of the Code (see Sec. 1.6049-4(c)(1)(ii)(H) and (M)).

(xiii) Amounts derived by a foreign central bank of issue from bankers' acceptances described in section 871(i)(2)(C) or 881(d) are exempt from tax and, therefore, from withholding. See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is a foreign central bank of issue as defined in Sec. 1.861-2(b)(4). See Sec. 1.1441-8(c)(2) for withholding procedures. See also Secs. 1.6049-4(c)(1)(ii)(H) and 1.6041-3(q)(8) for a similar exemption from information reporting.

(xiv) Payments to an international organization from investments in the United States of stocks, bonds, or other domestic securities or from interest on deposits in banks in the United States of funds belonging to such international organization are exempt from tax under section 892(b) and, thus, from withholding. Documentation establishing status as an international organization is not required if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is an international organization within the meaning of section 7701(a)(18). See Sec. 1.1441-8(d). Payments to an international organization are exempt from information reporting under chapter 61 of the Code (see Sec. 1.6049-4(c)(1)(ii)(G)).

(xv) Amounts may be exempt from, or subject to a reduced rate of, withholding under an income tax treaty. Documentation establishing eligibility for benefits under an income tax treaty is required for this purpose as provided under Secs. 1.1441-6. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, Sec. 1.6041-4(a)(1).

(xvi) Amounts of scholarships and grants paid to certain exchange or training program participants that do not represent compensation for services but are not excluded from tax under section 117 are subject to a reduced rate of withholding of 14-percent under section 1441(b). Documentation establishing foreign status is required for purposes of this reduction in rate as provided under Sec. 1.1441-4(c). This income is not subject to information reporting under chapter 61 of the Code nor to backup withholding under

section 3406. The compensatory portion of a scholarship or grant is reportable as wage income. See Sec. 1.6041-3(o).

(xvii) Amounts paid to a foreign organization described in section 501(c) are exempt from withholding under section 1441 to the extent that the amounts are not income includible under section 512 in computing the organization's unrelated business taxable income and are not subject to the tax imposed by section 4948(a). Documentation establishing status as a tax-exempt organization is required for purposes of this exemption to the extent provided in Sec. 1.1441-9. Amounts includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding to the extent provided in section 1443(a) and Sec. 1.1443-1(a). Gross investment income (as defined in section 4940(c)(2)) of a private foundation is subject to withholding at a 4-percent rate to the extent provided in section 1443(b) and Sec. 1.1443-1(b). Payments to a tax-exempt organization are exempt from information reporting under chapter 61 of the Code and the regulations thereunder (see Sec. 1.6049-4(c)(1)(ii)(B)(1)).

(xviii) Per diem amounts for subsistence paid by the U.S. government to a nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954 are exempt from withholding under section 1441(a). See section 1441(c)(6). Documentation of foreign status is not required under Sec. 1.1441-4(e) for purposes of establishing eligibility for this exemption. See Sec. 1.6041-3(p).

(xix) Interest with respect to tax-free covenant bonds issued prior to 1934 is subject to special withholding procedures set forth in Sec. 1.1461-1 in effect prior to January 1, 2001 (see Sec. 1.1461-1 as contained in 26 CFR part 1, revised April 1, 1999).

(xx) Income from certain gambling winnings of a nonresident alien individual is exempt from tax under section 871(j) and from withholding under section 1441(a). See section 1441(c)(11). Documentation establishing foreign status is not required for purposes of this exemption but may have to be furnished for purposes of the information reporting provisions of section 6041 and backup withholding under section 3406. See Secs. 1.6041-1 and 1.6041-4(a)(1).

(xxi) Any payments not otherwise mentioned in this paragraph (b)(4) shall be subject to withholding at the rate of 30-percent if it is an amount subject to withholding (as defined in Sec. 1.1441-2(a)) unless and to the extent the IRS may otherwise prescribe in

published guidance (see Sec. 601.601(d)(2) of this chapter) or unless otherwise provided in regulations under chapter 3 of the Code.

(5) Establishing foreign status under applicable provisions of chapter 61 of the Code.

This paragraph (b)(5) identifies relevant provisions of the regulations under chapter 61 of the Code that exempt payments from information reporting, and therefore, from backup withholding under section 3406, based on the payee's status as a foreign person. Many of these exemptions require that the payee's foreign status be established in order for the exemption to apply. The regulations under applicable provisions of chapter 61 of the Code generally provide that the documentation described in this section may be relied upon for purposes of determining foreign status.

(i) Payments to a foreign person that are governed by section 6041 (dealing with certain trade or business income) are exempt from information reporting under Sec. 1.6041-4(a).

(ii) Payments to a foreign person that are governed by section 6041A (dealing with remuneration for services and certain sales) are exempt from information reporting under Sec. 1.6041A-1(d)(3).

(iii) Payments to a foreign person that are governed by section 6042 (dealing with dividends) are exempt from information reporting under Sec. 1.6042-3(b)(1) (iii) through (vi).

(iv) Payments to a foreign person that are governed by section 6044 (dealing with patronage dividends) are exempt from information reporting under Sec. 1.6044-3(c)(1).

(v) Payments to a foreign person that are governed by section 6045 (dealing with broker proceeds) are exempt from information reporting under Sec. 1.6045-1(g).

(vi) Payments to a foreign person that are governed by section 6049 (dealing with interest) to a foreign person are exempt from information reporting under Sec. 1.6049-5(b) (6) through (15).

(vii) Payments to a foreign person that are governed by section 6050N (dealing with royalties) are exempt from information reporting under Sec. 1.6050N-1(c).

(viii) Payments to a foreign person that are governed by section 6050P (dealing with income from cancellation of debt) are exempt from information reporting under section 6050P or the regulations under that section except to the extent provided in Notice

96-61 (1996-2 C.B. 227); see also Sec. 601.601(b)(2) of this chapter.

(6) Rules of withholding for payments by a foreign intermediary or certain U.S. branches.

(i) In general.

A foreign intermediary described in paragraph (e)(3)(i) of this section or a U.S. branch described in paragraph (b)(2)(iv) of this section that receives an amount subject to withholding (as defined in Sec. 1.1441-2(a)) shall be required to withhold (if another withholding agent has not withheld the full amount required) and report such payment under chapter 3 of the Internal Revenue Code and the regulations thereunder except as otherwise provided in this paragraph (b)(6). A nonqualified intermediary or U.S. branch described in paragraph (b)(2)(iv) of this section (other than a branch that is treated as a U.S. person) shall not be required to withhold or report if it has provided a valid nonqualified intermediary withholding certificate or a U.S. branch withholding certificate, it has provided all of the information required by paragraph (e)(3)(iv) of this section (withholding statement), and it does not know, and has no reason to know, that another withholding agent failed to withhold the correct amount or failed to report the payment correctly under Sec. 1.1461-1(c). A qualified intermediary's obligations to withhold and report shall be determined in accordance with its qualified intermediary withholding agreement.

(ii) Examples.

The following examples illustrate the rules of paragraph (b)(6)(i) of this section:

Example 1. FB, a foreign bank, acts as intermediary for five different persons, A, B, C, D, and E, each of whom owns U.S. securities that generate U.S. source dividends. The dividends are paid by USWA, a U.S. withholding agent. FB furnished USWA with a nonqualified intermediary withholding certificate, described in paragraph (e)(3)(iii) of this section, to which it attached the withholding certificates of each of A, B, C, D, and E. The withholding certificates from A and B claim a 15 percent reduced rate of withholding under an income tax treaty. C, D, and E claim no reduced rate of withholding. FB provides a withholding statement that meets all of the requirements of paragraph (e)(3)(iv) of this section, including information allocating 20 percent of each dividend payment to each of A, B, C, D, and E. FB does not have actual knowledge or reason to know that USWA did not withhold the correct amounts or report the dividends on Forms 1042-S to each of A, B, C, D, and E. FB is not required to

withhold or to report the dividends to A, B, C, D, and E.

Example 2. The facts are the same as in Example 1, except that FB did not provide any information for USWA to determine how much of the dividend payments were made to A, B, C, D, and E. Because USWA could not reliably associate the dividend payments with documentation under paragraph (b)(2)(vii) of this section, USWA applied the presumption rules of paragraph (b)(3)(v) of this section and withheld 30 percent from all dividend payments. In addition, USWA filed a single Form 1042-S reporting the payment to an unknown foreign payee. FB is deemed to know that USWA did not report the payment to A, B, C, D, and E because it did not provide all of the information required on a withholding statement under paragraph (e)(3)(iv) of this section (i.e., allocation information). Although FB is not required to withhold on the payment because the full 30 percent withholding was imposed by USWA, it is required to report the payments on Forms 1042-S to A, B, C, D, and E. FB's intentional failure to do so will subject it to intentional disregard penalties under sections 6721 and 6722.

(7) Liability for failure to obtain documentation timely or to act in accordance with applicable presumptions.

(i) General rule.

A withholding agent that cannot reliably associate a payment with documentation on the date of payment and that does not withhold under this section, or withholds at less than the 30-percent rate prescribed under section 1441(a) and paragraph (b)(1) of this section, is liable under section 1461 for the tax required to be withheld under chapter 3 of the Code and the regulations thereunder, without the benefit of a reduced rate unless--

(A) The withholding agent has appropriately relied on the presumptions described in paragraph (b)(3) of this section (including the grace period described in paragraph (b)(3)(iv) of this section) in order to treat the payee as a U.S. person or, if applicable, on the presumptions described in Sec. 1.1441-4(a)(2)(ii) or (3)(i) to treat the payment as effectively connected income; or

(B) The withholding agent can demonstrate to the satisfaction of the district director or the Assistant Commissioner (International) that the proper amount of tax, if any, was in fact paid to the IRS; or

(C) No documentation is required under section 1441 or this section in order for a reduced rate of withholding to apply.

(ii) Proof that tax liability has been satisfied.

Proof of payment of tax may be established for purposes of paragraph (b)(7)(i)(B) of this section on the basis of a Form 4669 (or such other form as the IRS may prescribe in published guidance (see Sec. 601.601(d)(2) of this chapter)), establishing the amount of tax, if any, actually paid by or for the beneficial owner on the income. Proof that a reduced rate of withholding was, in fact, appropriate under the provisions of chapter 3 of the Code and the regulations thereunder may also be established after the date of payment by the withholding agent on the basis of a valid withholding certificate or other appropriate documentation furnished after that date. However, in the case of a withholding certificate or other appropriate documentation received after the date of payment (or after the grace period specified in paragraph (b)(3)(iv) of this section), the district director or the Assistant Commissioner (International) may require additional proof if it is determined that the delays in obtaining the withholding certificate affect its reliability.

(iii) Liability for interest and penalties.

A withholding agent that has failed to withhold other than based on appropriate reliance on the presumptions described in paragraph (b)(3) of this section or in Sec. 1.1441-4(a)(2)(ii) or (3)(i) is not relieved from liability for interest under section 6601. Such liability exists even if there is no underlying tax liability due. The interest on the amount that should have been withheld shall be imposed as prescribed under section 6601 beginning on the last date for paying the tax due under section 1461 (which, under section 6601, is the due date for filing the withholding agent's return of tax). The interest shall stop accruing on the earlier of the date that the required withholding certificate or other documentation is provided to the withholding agent and to the extent of the amount of tax that is determined not to be due based on documentation provided, or the date, and to the extent, that the unpaid tax liability under section 871, 881 or under section 1461 is satisfied. Further, in the event that a tax liability is assessed against the beneficial owner under section 871, 881, or 882 and interest under section 6601(a) is assessed against, and collected from, the beneficial owner, the interest charge imposed on the withholding agent shall be abated to that extent so as to avoid the imposition of a double interest charge. However, the withholding agent is not relieved of any applicable

penalties. See section 1464.

(iv) Special effective date.

See paragraph (f)(2)(ii) of this section for the special effective date applicable to this paragraph (b)(7).

(v) Examples.

The provisions of paragraph (b)(7) of this section are illustrated by the following examples:

Example 1. On June 15, 2001, a withholding agent pays U.S. source interest on an obligation in registered form (issued after July 18, 1984) to a foreign corporation that it cannot reliably associate with a Form W-8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2003, the withholding agent receives from the foreign corporation a valid Form W-8 described in paragraph (e)(2)(ii) of this section. Thus, the interest qualifies as portfolio interest retroactively to June 15, 2001 (the date of payment). See Sec. 1.871-14(c)(3). The foreign corporation does not file a U.S. federal income tax return and does not pay the tax owed. The withholding agent is not liable under section 1461 for the 30-percent tax on the interest income because the receipt of the Form W-8 exempts the interest from tax for purposes of sections 881(a) and 1461. The withholding agent, however, is liable for interest on the amount of withholding that should have been deducted from the payment on June 15, 2001 and deposited. Under paragraph (b)(7)(iii) of this section, the period during which interest may be assessed against the withholding agent runs from March 15, 2002 (the due date for the Form 1042 relating to the payment) until September 30, 2003 (i.e., the date that appropriate documentation is furnished to the withholding agent).

Example 2. On June 15, 2001, a withholding agent pays U.S. source dividends to a foreign corporation that it cannot reliably associate with a Form W-8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2003, the withholding agent receives from the foreign corporation a valid Form W-8 described in paragraph (e)(2)(ii) of this section claiming a reduced 15-percent rate of withholding under a U.S. income tax treaty. The dividend qualifies for the reduced treaty rate retroactively to June 15, 2001 (the date of payment). The foreign corporation does

not file a U.S. federal income tax return and does not pay the tax owed. Under section 1461, the withholding agent is liable only for a 15-percent tax on the dividend income because the receipt of the Form W-8 allows the tax rate to be reduced for purposes of sections 881(a) and 1461 from 30 percent to 15 percent. The withholding agent, however, is liable for interest on the full 30-percent amount that should have been deducted and withheld from the payment on June 15, 2001, and deposited, over a period running from March 15, 2002 (the due date for the Form 1042 relating to the payment) until September 30, 2003 (the date that the appropriate documentation is furnished to the withholding agent supporting a reduction in rate under a tax treaty). Additional interest may be assessed relating to the outstanding 15-percent tax liability (i.e., the portion of the 30-percent total tax liability that is not reduced under the treaty). Such additional interest runs from March 15, 2002, until such date as that 15-percent tax liability is satisfied by the withholding agent or the taxpayer (subject to abatement in order to avoid a double interest charge).

(8) Adjustments, refunds, or credits of overwithheld amounts.

If the amount withheld under section 1441, 1442, or 1443 is greater than the tax due by the withholding agent or the taxpayer, adjustments may be made in accordance with the procedures described in Sec. 1.1461-2(a). Alternatively, refunds or credits may be claimed in accordance with the procedures described in Sec. 1.1464-1, relating to refunds or credits claimed by the beneficial owner, or Sec. 1.6414-1, relating to refunds or credits claimed by the withholding agent. If an amount was withheld under section 3406 or is subsequently determined to have been paid to a foreign person, see paragraph (b)(3)(vii) of this section and Sec. 31.6413(a)-3(a)(1) of this chapter.

(9) Payments to joint owners.

A payment to joint owners that requires documentation in order to reduce the rate of withholding under chapter 3 of the Code and the regulations thereunder does not qualify for such reduced rate unless the withholding agent can reliably associate the payment with documentation from each owner. Notwithstanding the preceding sentence, a payment to joint owners qualifies as a payment exempt from withholding under this section if any one of the owners provides a certificate of U.S. status on a Form W-9 in accordance with paragraph (d)(2) or (3) of this section or the withholding agent can associate the payment with an intermediary or flow-through withholding certificate upon which it can rely to treat the payment as made to a U.S. payee under paragraph (d)(4) of this section. See Sec.

31.3406(h)-2(a)(3)(i)(B) of this chapter.

(c) Definitions

(1) Withholding.

The term withholding means the deduction and withholding of tax at the applicable rate from the payment.

(2) Foreign and U.S. person.

The term foreign person means a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate, and any other person that is not a U.S. person described in the next sentence. Solely for purposes of the regulations under chapter 3 of the Internal Revenue Code, the term foreign person also means, with respect to a payment by a withholding agent, a foreign branch of a U.S. person that furnishes an intermediary withholding certificate described in paragraph (e)(3)(ii) of this section. Such a branch continues to be a U.S. payor for purposes of chapter 61 of the Internal Revenue Code. See Sec. 1.6049-5(c)(4). A U.S. person is a person described in section 7701(a)(30), the U.S. government (including an agency or instrumentality thereof), a State (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

(3) Individual.

(i) Alien individual.

The term alien individual means an individual who is not a citizen or a national of the United States. See Sec. 1.1-1(c).

(ii) Nonresident alien individual.

The term nonresident alien individual means a person described in section 7701(b)(1)(B), an alien individual who is a resident of a foreign country under the residence article of an income tax treaty and Sec. 301.7701(b)-7(a)(1) of this chapter, or an alien individual who is a resident of Puerto Rico, Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, or American Samoa as determined under Sec. 301.7701(b)-1(d) of this chapter. An alien individual who has made an election under section 6013 (g) or (h) to be treated as a resident of the United States is nevertheless treated as a nonresident alien individual for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(4) Certain foreign corporations.

For purposes of this section, a corporation created or organized in Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa, is not treated as a foreign corporation if the requirements of sections 881(b)(1) (A), (B), and (C) are met for such corporation. Further, a payment made to a foreign government or an international organization shall be treated as a payment made to a foreign corporation for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(5) Financial institution and foreign financial institution.

For purposes of the regulations under chapter 3 of the Code, the term financial institution means a person described in Sec. 1.165-12(c)(1)(iv) (not including a person providing pension or other similar benefits or a regulated investment company or other mutual fund, unless otherwise indicated) and the term foreign financial institution means a financial institution that is a foreign person, as defined in paragraph (c)(2) of this section.

(6) Beneficial owner.

(i) General rule.

This paragraph (c)(6) defines the term beneficial owner for payments of income other than a payment for which a reduced rate of withholding is claimed under an income tax treaty. The term beneficial owner means the person who is the owner of the income for tax purposes and who beneficially owns that income. A person shall be treated as the owner of the income to the extent that it is required under U.S. tax principles to include the amount paid in gross income under section 61 (determined without regard to an exclusion or exemption from gross income under the Internal Revenue Code). Beneficial ownership of income is determined under the provisions of section 7701(l) and the regulations under that section and any other applicable general U.S. tax principles, including principles governing the determination of whether a transaction is a conduit transaction. Thus, a person receiving income in a capacity as a nominee, agent, or custodian for another person is not the beneficial owner of the income. In the case of a scholarship, the student receiving the scholarship is the beneficial owner of that scholarship. In the case of a payment of an amount that is not income, the beneficial owner determination shall be made under this paragraph (c)(6) as if the amount were income.

(ii) Special rules.

(A) General rule.

The beneficial owners of income paid to an entity described in this paragraph (c)(6)(ii) are those persons described in paragraphs (c)(6)(ii)(B) through (D) of this section.

(B) Foreign partnerships.

The beneficial owners of income paid to a foreign partnership (whether a nonwithholding or a withholding foreign partnership) are the partners in the partnership, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6). For example, a partnership (first tier) that is a partner in another partnership (second tier) is not the beneficial owner of income paid to the second tier partnership since the first tier partnership is not the owner of the income under U.S. tax principles. Rather, the partners of the first tier partnership are the beneficial owners (to the extent they are not themselves persons that are not beneficial owners under this paragraph (c)(6)). See Sec. 1.1441-5(b) for applicable withholding procedures for payments to a domestic partnership. See also Sec. 1.1441-5(c)(3)(ii) for applicable withholding procedures for payments to a foreign partnership where one of the partners (at any level in the chain of tiers) is a domestic partnership.

(C) Foreign simple trusts and foreign grantor trusts.

The beneficial owners of income paid to a foreign simple trust, as described in paragraph (c)(23) of this section, are the beneficiaries of the trust, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6). The beneficial owners of income paid to a foreign grantor trust, as described in paragraph (c)(26) of this section, are the persons treated as the owners of the trust, unless they themselves are not the beneficial owners of the income under this paragraph (c)(6).

(D) Other foreign trusts and foreign estates.

The beneficial owner of income paid to a foreign complex trust as defined in paragraph (c)(25) of this section or to a foreign estate is the foreign complex trust or estate itself.

(7) Withholding agent.

For a definition of the term withholding agent and applicable rules, see Sec. 1.1441-7.

(8) Person.

For purposes of the regulations under chapter 3 of the Code, the term person shall mean a person described in section 7701(a)(1) and the regulations under that section and a U.S. branch to the extent treated as a U.S. person under paragraph (b)(2)(iv) of this section. For purposes of the regulations under chapter 3 of the Code, the term person does not include a wholly-owned entity that is disregarded for federal tax purposes under Sec. 301.7701-2(c)(2) of this chapter as an entity separate from its owner. See paragraph (b)(2)(iii) of this section for procedures applicable to payments to such entities.

(9) Source of income.

The source of income is determined under the provisions of part I (section 861 and following) , subchapter N, chapter 1 of the Code and the regulations under those provisions.

(10) Chapter 3 of the Code.

For purposes of the regulations under sections 1441, 1442, and 1443, any reference to chapter 3 of the Code shall not include references to sections 1445 and 1446, unless the context indicates otherwise.

(11) Reduced rate.

For purposes of regulations under chapter 3 of the Code, and other withholding provisions of the Code, the term reduced rate, when used in regulations under chapter 3 of the Code, shall include an exemption from tax.

(12) Payee.

For purposes of chapter 3 of the Internal Revenue Code, the term payee of a payment is determined under paragraph (b)(2) of this section, Sec. 1.1441-5(c)(1) (relating to partnerships), and Sec. 1.1441-5(e)(2) and (3) (relating to trusts and estates) and includes foreign persons, U.S. exempt recipients, and U.S. non-exempt recipients. A nonqualified intermediary and a qualified intermediary (to the extent it does not assume primary withholding responsibility) are not payees if they are acting as intermediaries and not the beneficial owner of income. In addition, a flow-through entity is not a payee unless the income is (or is deemed to be) effectively connected with the conduct of a trade or business in the United States. See Sec. 1.6049-5(d)(1) for rules to determine the payee for purposes of chapter 61 of the Internal Revenue Code. See Secs. 1.1441-1(b)(3), 1.1441-5(d), and (e)(6) and 1.6049-5(d)(3) for

presumption rules that apply if a payee's identity cannot be determined on the basis of valid documentation.

(13) Intermediary.

An intermediary means, with respect to a payment that it receives, a person that, for that payment, acts as a custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether such other person is the beneficial owner of the amount paid, a flow-through entity, or another intermediary.

(14) Nonqualified intermediary.

A nonqualified intermediary means any intermediary that is not a U.S. person and not a qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, or a qualified intermediary that is not acting in its capacity as a qualified intermediary with respect to a payment. For example, to the extent an entity that is a qualified intermediary provides another withholding agent with a foreign beneficial owner withholding certificate as defined in paragraph (e)(2)(i) of this section, the entity is not acting in its capacity as a qualified intermediary. Notwithstanding the preceding sentence, a qualified intermediary is acting as a qualified intermediary to the extent it provides another withholding agent with Forms W-9, or other information regarding U.S. non-exempt recipients pursuant to its qualified intermediary agreement with the IRS.

(15) Qualified intermediary.

The term qualified intermediary is defined in paragraph (e)(5)(ii) of this section.

(16) Withholding certificate.

The term withholding certificate means a Form W-8 described in paragraph (e)(2)(i) of this section (relating to foreign beneficial owners), paragraph (e)(3)(i) of this section (relating to foreign intermediaries), Sec. 1.1441-5(c)(2)(iv), (c)(3)(iii), and (e)(3)(iv) (relating to flow-through entities), a Form 8233 described in Sec. 1.1441-4(b)(2), a Form W-9 as described in paragraph (d) of this section, a statement described in Sec. 1.871- 14(c)(2)(v) (relating to portfolio interest), or any other certificates that under the Internal Revenue Code or regulations certifies or establishes the status of a payee or beneficial owner as a U.S. or a foreign person.

(17) Documentary evidence; other appropriate documentation.

The terms documentary evidence or other appropriate documentation refer to documents other than a withholding certificate that may be provided for payments made outside the United States

to offshore accounts or any other evidence that under the Internal Revenue Code or regulations certifies or establishes the status of a payee or beneficial owner as a U.S. or foreign person. See Secs. 1.1441-6(b)(2), (c)(3) and (4) (relating to treaty benefits), and 1.6049-5(c)(1) and (4) (relating to chapter 61 reporting). Also see Sec. 1.1441-4(a)(3)(ii) regarding documentary evidence for notional principal contracts.

(18) Documentation.

The term documentation refers to both withholding certificates, as defined in paragraph (c)(16) of this section, and documentary evidence or other appropriate documentation, as defined in paragraph (c)(17) of this section.

(19) Payor.

The term payor is defined in Sec. 31.3406(a)-2 of this chapter and Sec. 1.6049-4(a)(2) and generally includes a withholding agent, as defined in Sec. 1.1441-7(a). The term also includes any person that makes a payment to an intermediary, flow-through entity, or U.S. branch that is not treated as a U.S. person to the extent the intermediary, flow-through, or U.S. branch provides a Form W-9 or other appropriate information relating to a payee so that the payment can be reported under chapter 61 of the Internal Revenue Code and, if required, subject to backup withholding under section 3406. This latter rule does not preclude the intermediary, flow-through entity, or U.S. branch from also being a payor.

(20) Exempt recipient.

The term exempt recipient means a person that is exempt from reporting under chapter 61 of the Internal Revenue Code and backup withholding under section 3406 and that is described in Secs. 1.6041-3(q), 1.6045-2(b)(2)(i), and 1.6049-4(c)(1)(ii), and Sec. 5f.6045-1(c)(3)(i)(B) of this chapter. Exempt recipients are not exempt from withholding under chapter 3 of the Internal Revenue Code unless they are U.S. persons or foreign persons entitled to an exemption from withholding under chapter 3.

(21) Non-exempt recipient.

A non-exempt recipient is any person that is not an exempt recipient under paragraph (c)(20) of this section.

(22) Reportable amounts.

Reportable amounts are defined in paragraph (e)(3)(vi) of this section.

(23) Flow-through entity.

A flow-through entity means any entity that is described in this paragraph (c)(23) and that may provide documentation on behalf of others to a withholding agent. The entities described in this paragraph are a foreign partnership (other than a withholding foreign partnership), a foreign simple trust (other than a withholding foreign trust) that is described in paragraph (c)(24) of this section, a foreign grantor trust (other than a withholding foreign trust) that is described in paragraph (c)(25) of this section, or, for any payments for which a reduced rate of withholding under an income tax treaty is claimed, any entity to the extent the entity is considered to be fiscally transparent under section 894 with respect to the payment by an interest holder's jurisdiction.

(24) Foreign simple trust.

A foreign simple trust is a foreign trust that is described in section 651(a).

(25) Foreign complex trust.

A foreign complex trust is a foreign trust other than a trust described in section 651(a) or sections 671 through 679.

(26) Foreign grantor trust.

A foreign grantor trust is a foreign trust but only to the extent all or a portion of the income of the trust is treated as owned by the grantor or another person under sections 671 through 679.

(27) Partnership.

The term partnership means any entity treated as a partnership under Sec. 301.7701-2 or -3 of this chapter.

(28) Nonwithholding foreign partnership.

A nonwithholding foreign partnership is a foreign partnership that is not a withholding foreign partnership, as defined in Sec. 1.1441-5(c)(2)(i).

(29) Withholding foreign partnership.

A withholding foreign partnership is defined in Sec. 1.1441-5(c)(2)(i).

(d) Beneficial owner's or payee's claim of U.S. status.

(1) In general.

Under paragraph (b)(1) of this section, a withholding agent is not required to withhold under chapter 3 of the Code on payments to a U.S. payee, to a person presumed to be a U.S. payee in accordance with the provisions of paragraph (b)(3) of this section, or to a person that the withholding agent may treat as a U.S. beneficial owner of the payment. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on the provisions of this paragraph (d) in order to determine whether to treat a payee or beneficial owner as a U.S. person.

(2) Payments for which a Form W-9 is otherwise required.

A withholding agent may treat as a U.S. payee any person who is required to furnish a Form W-9 and who furnishes it in accordance with the procedures described in Secs. 31.3406(d)-1 through 31.3406(d)-5 of this chapter (including the requirement that the payee furnish its taxpayer identifying number (TIN)) if the withholding agent meets all the requirements described in Sec. 31.3406(h)-3(e) of this chapter regarding reliance by a payor on a Form W-9. Providing a Form W-9 or valid substitute form shall serve as a statement that the person whose name is on the form is a U.S. person. Therefore, a foreign person, including a U.S. branch treated as a U.S. person under paragraph (b)(2)(iv) of this section, shall not provide a Form W-9. A U.S. branch of a foreign person may establish its status as a foreign person exempt from reporting under chapter 61 and backup withholding under section 3406 by providing a withholding certificate on Form W-8.

(3) Payments for which a Form W-9 is not otherwise required.

In the case of a payee who is not required to furnish a Form W-9 under section 3406 (e.g., a person exempt from reporting under chapter 61 of the Internal Revenue Code), the withholding agent may treat the payee as a U.S. payee if the payee provides the withholding agent with a Form W-9 or a substitute form described in Sec. 31.3406(h)-3(c)(2) of this chapter (relating to forms for exempt recipients) that contains the payee's name, address, and TIN. The form must be signed under penalties of perjury by the payee if so required by the form or by Sec. 31.3406(h)-3 of this chapter. Providing a Form W-9 or valid substitute form shall serve as a statement that the person whose name is on the certificate is a U.S. person. A Form W-9 or valid substitute form shall not be provided by a foreign person, including any U.S. branch of a foreign person whether or not the branch is treated as a U.S. person under paragraph (b)(2)(iv) of this section. See paragraph (e)(3)(v) of this section for withholding certificates provided by U.S. branches described in paragraph (b)(2)(iv) of this section. The procedures described in

Sec. 31.3406(h)-2(a) of this chapter shall apply to payments to joint payees. A withholding agent that receives a Form W-9 to satisfy this paragraph (d)(3) must retain the form in accordance with the provisions of Sec. 31.3406(h)-3(g) of this chapter, if applicable, or of paragraph (e)(4)(iii) of this section (relating to the retention of withholding certificates) if Sec. 31.3406(h)-3(g) of this chapter does not apply. The rules of this paragraph (d)(3) are only intended to provide a method by which a withholding agent may determine that a payee is a U.S. person and do not otherwise impose a requirement that documentation be furnished by a person who is otherwise treated as an exempt recipient for purposes of the applicable information reporting provisions under chapter 61 of the Internal Revenue Code (e.g., Sec. 1.6049-4(c)(1)(ii) for payments of interest).

(4) When a payment to an intermediary or flow-through entity may be treated as made to a U.S. payee.

A withholding agent that makes a payment to an intermediary (whether a qualified intermediary or nonqualified intermediary), a flow-through entity, or a U.S. branch described in paragraph (b)(2)(iv) of this section may treat the payment as made to a U.S. payee to the extent that, prior to the payment, the withholding agent can reliably associate the payment with a Form W-9 described in paragraph (d)(2) or (3) of this section attached to a valid intermediary, flow-through, or U.S. branch withholding certificate described in paragraph (e)(3)(i) of this section or to the extent the withholding agent can reliably associate the payment with a Form W-8 described in paragraph (e)(3)(v) of this section that evidences an agreement to treat a U.S. branch described in paragraph (b)(2)(iv) of this section as a U.S. person. In addition, a withholding agent may treat the payment as made to a U.S. payee only if it complies with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section, if required, and it has not been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. In the case of a Form W-9 that is required to be furnished for a reportable payment that may be subject to backup withholding, the withholding agent may be notified in accordance with section 3406(a)(1)(B) and the regulations under that section. See applicable procedures under section 3406(a)(1)(B) and the regulations under that section for payors who have been notified with regard to such a Form W-9. Withholding agents who have been notified in relation to other Forms W-9, including under section 6724(b) pursuant to section 6721, may rely on the withholding certificate or other documentation only to the extent provided under procedures as prescribed by the IRS (see Sec. 601.601(d)(2) of this chapter).

(e) Beneficial owner's claim of foreign status.

(1) Withholding agent's reliance

(i) In general.

Absent actual knowledge or reason to know otherwise, a withholding agent may treat a payment as made to a foreign beneficial owner in accordance with the provisions of paragraph (e)(1)(ii) of this section. See paragraph (e)(4)(viii) of this section for applicable reliance rules. See paragraph (b)(4) of this section for a description of payments for which a claim of foreign status is relevant for purposes of claiming a reduced rate of withholding for purposes of section 1441, 1442, or 1443. See paragraph (b)(5) of this section for a list of payments for which a claim of foreign status is relevant for other purposes, such as claiming an exemption from information reporting under chapter 61 of the Code.

(ii) Payments that a withholding agent may treat as made to a foreign person that is a beneficial owner.

(A) General rule.

The withholding agent may treat a payment as made to a foreign person that is a beneficial owner if it complies with the requirements described in paragraph (e)(1)(ii)(B) of this section and, then, only to the extent--

(1) That the withholding agent can reliably associate the payment with a beneficial owner withholding certificate described in paragraph (e)(2) of this section furnished by the person whose name is on the certificate or attached to a valid foreign intermediary, flow-through, or U.S. branch withholding certificate;

(2) That the payment is made outside the United States (within the meaning of Sec. 1.6049-5(e)) to an offshore account (within the meaning of Sec. 1.6049-5(c)(1)) and the withholding agent can reliably associate the payment with documentary evidence described in Secs. 1.1441-6(c)(3) or (4), or 1.6049-5(c)(1) relating to the beneficial owner;

(3) That the withholding agent can reliably associate the payment with a valid qualified intermediary withholding certificate, as described in paragraph (e)(3)(ii) of this section, and the qualified intermediary has provided sufficient information for the withholding agent to allocate the

payment to a withholding rate pool other than a withholding rate pool or pools established for U.S. non-exempt recipients;

(4) That the withholding agent can reliably associate the payment with a withholding certificate described in Sec. 1.1441-5(c)(3)(iii) or (e)(5)(iii) from a flow-through entity claiming the income is effectively connected income;

(5) That the withholding agent identifies the payee as a U.S. branch described in paragraph (b)(2)(iv) of this section, the payment to which it treats as effectively connected income in accordance with Sec. 1.1441-4(a) (2)(ii) or (3);

(6) That the withholding agent identifies the payee as an international organization (or any wholly-owned agency or instrumentality thereof) as defined in section 7701(a)(18) that has been designated as such by executive order (pursuant to 22 U.S.C. 288 through 288(f)); or

(7) That the withholding agent pays interest from bankers' acceptances and identifies the payee as a foreign central bank of issue (as defined in Sec. 1.861-2(b)(4)).

(B) Additional requirements.

In order for a payment described in paragraph (e)(1)(ii)(A) of this section to be treated as made to a foreign beneficial owner, the withholding agent must hold the documentation (if required) prior to the payment, comply with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section (if required), and must not have been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. If the withholding agent has been so notified, it may rely on the withholding certificate or other documentation only to the extent provided under procedures prescribed by the IRS (see Sec. 601.601(d)(2) of this chapter). See paragraph (b)(2)(vii) of this section for rules regarding reliable association of a payment with a withholding certificate or other appropriate documentation.

(2) Beneficial owner withholding certificate.

(i) In general.

A beneficial owner withholding certificate is a statement by which the beneficial owner of the payment represents that it is a foreign person and, if applicable, claims a reduced rate of withholding under section 1441. A separate withholding certificate must be submitted to each withholding agent. If the beneficial owner receives more than one type of payment from a single withholding agent, the beneficial owner may have to submit more than one withholding certificate to the single withholding agent for the different types of payments as may be required by the applicable forms and instructions, or as the withholding agent may require (such as to facilitate the withholding agent's compliance with its obligations to determine withholding under this section or the reporting of the amounts under Sec. 1.1461-1 (b) and (c)). For example, if a beneficial owner claims that some but not all of the income it receives is effectively connected with the conduct of a trade or business in the United States, it may be required to submit two separate withholding certificates, one for income that is not effectively connected and one for income that is so connected. See Sec. 1.1441-6(b)(2) for special rules for determining who must furnish a beneficial owner withholding certificate when a benefit is claimed under an income tax treaty. See paragraph (e)(4)(ix) of this section for reliance rules in the case of certificates held by another person or at a different branch location of the same person.

(ii) Requirements for validity of certificate.

A beneficial owner withholding certificate is valid only if it is provided on a Form W-8, or a Form 8233 in the case of personal services income described in Sec. 1.1441-4(b) or certain scholarship or grant amounts described in Sec. 1.1441-4(c) (or a substitute form described in paragraph (e)(4)(vi) of this section, or such other form as the IRS may prescribe). A Form W-8 is valid only if its validity period has not expired, it is signed under penalties of perjury by the beneficial owner, and it contains all of the information required on the form. The required information is the beneficial owner's name, permanent residence address, and TIN (if required), the country under the laws of which the beneficial owner is created, incorporated, or governed (if a person other than an individual), the classification of the entity, and such other information as may be required by the regulations under section 1441 or by the form or accompanying instructions in addition to, or in lieu of, the information described in this paragraph (e)(2)(ii). A person's permanent residence address is an address in the country where the person claims to be a resident for purposes of that country's income tax. In the case of a certificate furnished in order to claim a reduced rate of withholding under an income tax treaty, the residence must be determined in the manner prescribed under the

applicable treaty. See Sec. 1.1441-6(b). The address of a financial institution with which the beneficial owner maintains an account, a post office box, or an address used solely for mailing purposes is not a residence address for this purpose. If the beneficial owner is an individual who does not have a tax residence in any country, the permanent residence address is the place at which the beneficial owner normally resides. If the beneficial owner is not an individual and does not have a tax residence in any country, then the permanent residence address is the place at which the person maintains its principal office. See paragraph (e)(4)(vii) of this section for circumstances in which a TIN is required on a beneficial owner withholding certificate. See paragraph (f)(2)(i) of this section for continued validity of certificates during a transition period.

(3) Intermediary, flow-through, or U.S. branch withholding certificate.

(i) In general.

An intermediary withholding certificate is a Form W-8 by which a payee represents that it is a foreign person and that it is an intermediary (whether a qualified or nonqualified intermediary) with respect to a payment and not the beneficial owner. See paragraphs (e)(3)(ii) and (iii) of this section. A flow-through withholding certificate is a Form W-8 used by a flow-through entity as defined in paragraph (c)(23) of this section. See Sec. 1.1441- 5(c)(3)(iii) (a nonwithholding foreign partnership), Sec. 1.1441- 5(e)(5)(iii) (a foreign simple trust or foreign grantor trust) or Sec. 1.1441-6(b)(2) (foreign entity presenting claims on behalf of its interest holders for a reduced rate of withholding under an income tax treaty). A U.S. branch certificate is a Form W-8 furnished under paragraph (e)(3)(v) of this section by a U.S. branch described in paragraph (b)(2)(iv) of this section. See paragraph (e)(4)(viii) of this section for applicable reliance rules.

(ii) Intermediary withholding certificate from a qualified intermediary.

A qualified intermediary shall provide a qualified intermediary withholding certificate for reportable amounts received by the qualified intermediary. See paragraph (e)(3)(vi) of this section for the definition of reportable amount. A qualified intermediary withholding certificate is valid only if it is furnished on a Form W-8, an acceptable substitute form, or such other form as the IRS may prescribe, it is signed under penalties of perjury by a person with authority to sign for the qualified intermediary, its validity has not expired, and it contains the following information, statement, and certifications--

(A) The name, permanent residence address (as described in paragraph (e)(2)(ii) of this section), qualified intermediary employer identification number

(QI-EIN), and the country under the laws of which the intermediary is created, incorporated, or governed. A qualified intermediary that does not act in its capacity as a qualified intermediary must not use its QI-EIN. Rather the intermediary should provide a nonqualified intermediary withholding certificate, if it is acting as an intermediary, and should use the taxpayer identification number, if any, that it uses for all other purposes;

(B) A certification that, with respect to accounts it identifies on its withholding statement (as described in paragraph (e)(5)(v) of this section), the qualified intermediary is not acting for its own account but is acting as a qualified intermediary;

(C) A certification that the qualified intermediary has provided, or will provide, a withholding statement as required by paragraph (e)(5)(v) of this section; and

(D) Any other information, certifications, or statements as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (e)(3)(ii) or paragraph (e)(3)(v) of this section. See paragraph (e)(5)(v) of this section for the requirements of a withholding statement associated with the qualified intermediary withholding certificate.

(iii) Intermediary withholding certificate from a nonqualified intermediary.

A nonqualified intermediary shall provide a nonqualified intermediary withholding certificate for reportable amounts received by the nonqualified intermediary. See paragraph (e)(3)(vi) of this section for the definition of reportable amount. A nonqualified intermediary withholding certificate is valid only to the extent it is furnished on a Form W-8, an acceptable substitute form, or such other form as the IRS may prescribe, it is signed under penalties of perjury by a person authorized to sign for the nonqualified intermediary, it contains the information, statements, and certifications described in this paragraph (e)(3)(iii) and paragraph (e)(3)(iv) of this section, its validity has not expired, and the withholding certificates and other appropriate documentation for all persons to whom the certificate relates are associated with the certificate. Withholding certificates and other appropriate documentation consist of beneficial owner withholding certificates described in paragraph (e)(2)(i) of this section, intermediary and flow-through withholding certificates described in paragraph (e)(3)(i) of this section, withholding foreign partnership certificates described in Sec.

1.1441-5(c)(2)(iv), documentary evidence described in Secs. 1.1441-6(c)(3) or (4) and 1.6049-5(c)(1), and any other documentation or certificates applicable under other provisions of the Internal Revenue Code or regulations that certify or establish the status of the payee or beneficial owner as a U.S. or a foreign person. If a nonqualified intermediary is acting on behalf of another nonqualified intermediary or a flow-through entity, then the nonqualified intermediary must associate with its own withholding certificate the other nonqualified intermediary withholding certificate or the flow-through withholding certificate and separately identify all of the withholding certificates and other appropriate documentation that are associated with the withholding certificate of the other nonqualified intermediary or flow-through entity. Nothing in this paragraph (e)(3)(iii) shall require an intermediary to furnish original documentation. Copies of certificates or documentary evidence may be transmitted to the U.S. withholding agent, in which case the nonqualified intermediary must retain the original documentation for the same time period that the copy is required to be retained by the withholding agent under paragraph (e)(4)(iii) of this section and must provide it to the withholding agent upon request. For purposes of this paragraph (e)(3)(iii), a valid intermediary withholding certificate also includes a statement described in Sec. 1.871-14(c)(2)(v) furnished for interest to qualify as portfolio interest for purposes of sections 871(h) and 881(c). The information and certifications required on a Form W-8 described in this paragraph (e)(3)(iii) are as follows--

(A) The name and permanent resident address (as described in paragraph (e)(2)(ii) of this section) of the nonqualified intermediary, and the country under the laws of which the nonqualified intermediary is created, incorporated, or governed;

(B) A certification that the nonqualified intermediary is not acting for its own account;

(C) If the nonqualified intermediary withholding certificate is used to transmit withholding certificates or other appropriate documentation for more than one person on whose behalf the nonqualified intermediary is acting, a withholding statement associated with the Form W-8 that provides all the information required by paragraph (e)(3)(iv) of this section; and

(D) Any other information, certifications, or statements as may be required by the form or accompanying instructions in addition to, or in lieu of, the information, certifications, and statements described in this paragraph (e)(3)(iii)

or paragraph (e)(5)(iv) of this section.

(iv) Withholding statement provided by nonqualified intermediary--

(A) In general.

A nonqualified intermediary shall provide a withholding statement required by this paragraph (e)(3)(iv) to the extent the nonqualified intermediary is required to furnish, or does furnish, documentation for payees on whose behalf it receives reportable amounts (as defined in paragraph (e)(3)(vi) of this section) or to the extent it otherwise provides the documentation of such payees to a withholding agent. A nonqualified intermediary is not required to disclose information regarding persons for whom it collects reportable amounts unless it has actual knowledge that any such person is a U.S. non- exempt recipient as defined in paragraph (c)(21) of this section. Information regarding U.S. non-exempt recipients required under this paragraph (e)(3)(iv) must be provided irrespective of any requirement under foreign law that prohibits the disclosure of the identity of an account holder of a nonqualified intermediary or financial information relating to such account holder. Although a nonqualified intermediary is not required to provide documentation and other information required by this paragraph (e)(3)(iv) for persons other than U.S. non-exempt recipients, a withholding agent that does not receive documentation and such information must apply the presumption rules of paragraph (b) of this section, Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d) or the withholding agent shall be liable for tax, interest, and penalties. A withholding agent must apply the presumption rules even if it is not required under chapter 61 of the Internal Revenue Code to obtain documentation to treat a payee as an exempt recipient and even though it has actual knowledge that the payee is a U.S. person. For example, if a nonqualified intermediary fails to provide a withholding agent with a Form W-9 for an account holder that is a U.S. exempt recipient, the withholding agent must presume (even if it has actual knowledge that the account holder is a U.S. exempt recipient), that the account holder is an undocumented foreign person with respect to amounts subject to withholding. See paragraph (b)(3)(v) of this section for applicable presumptions. Therefore, the withholding agent must withhold 30 percent from the payment even though if a Form W-9 had been provided, no withholding or reporting on the payment attributable to a U.S. exempt recipient would apply. Further, a nonqualified intermediary that fails to provide the documentation and the information under

this paragraph (e)(3)(iv) for another withholding agent to report the payments on Forms 1042-S and Forms 1099 is not relieved of its responsibility to file information returns. See paragraph (b)(6) of this section. Therefore, unless the nonqualified intermediary itself files such returns and provides copies to the payees, it shall be liable for penalties under sections 6721 (failure to file information returns), and 6722 (failure to furnish payee statements), including the penalties under those sections for intentional failure to file information returns. In addition, failure to provide either the documentation or the information required by this paragraph (e)(3)(iv) results in a payment not being reliably associated with valid documentation. Therefore, the beneficial owners of the payment are not entitled to reduced rates of withholding and if the full amount required to be held under the presumption rules is not withheld by the withholding agent, the nonqualified intermediary must withhold the difference between the amount withheld by the withholding agent and the amount required to be withheld. Failure to withhold shall result in the nonqualified intermediary being liable for tax under section 1461, interest, and penalties, including penalties under section 6656 (failure to deposit) and section 6672 (failure to collect and pay over tax).

(B) General requirements.

A withholding statement must be provided prior to the payment of a reportable amount and must contain the information specified in paragraph (e)(3)(iv)(C) of this section. The statement must be updated as often as required to keep the information in the withholding statement correct prior to each subsequent payment. The withholding statement forms an integral part of the withholding certificate provided under paragraph (e)(3)(iii) of this section, and the penalties of perjury statement provided on the withholding certificate shall apply to the withholding statement. The withholding statement may be provided in any manner the nonqualified intermediary and the withholding agent mutually agree, including electronically. If the withholding statement is provided electronically, there must be sufficient safeguards to ensure that the information received by the withholding agent is the information sent by the nonqualified intermediary and all occasions of user access that result in the submission or modification of the withholding statement information must be recorded. In addition, an electronic system must be capable of providing a hard copy of all withholding statements provided by the nonqualified intermediary. A withholding agent will be liable for

tax, interest, and penalties in accordance with paragraph (b)(7) of this section to the extent it does not follow the presumption rules of paragraph (b)(3) of this section or Secs. 1.1441-5(d) and (e)(6), and 1.6049-5(d) for any payment of a reportable amount, or portion thereof, for which it does not have a valid withholding statement prior to making a payment.

(C) Content of withholding statement.

The withholding statement provided by a nonqualified intermediary must contain the information required by this paragraph (e)(3)(iv)(C).

(1) The withholding statement must contain the name, address, TIN (if any) and the type of documentation (documentary evidence, Form W-9, or type of Form W-8) for every person from whom documentation has been received by the nonqualified intermediary and provided to the withholding agent and whether that person is a U.S. exempt recipient, a U.S. non-exempt recipient, or a foreign person. See paragraphs (c)(2), (20), and (21) of this section for the definitions of foreign person, U.S. exempt recipient, and U.S. non-exempt recipient. In the case of a foreign person, the statement must indicate whether the foreign person is a beneficial owner or an intermediary, flow-through entity, or U.S. branch described in paragraph (b)(2)(iv) of this section and include the type of recipient, based on recipient codes used for filing Forms 1042-S, if the foreign person is a recipient as defined in Sec. 1.1461- 1(c)(1)(ii).

(2) The withholding statement must allocate each payment, by income type, to every payee (including U.S. exempt recipients) for whom documentation has been provided. Any payment that cannot be reliably associated with valid documentation from a payee shall be treated as made to an unknown payee in accordance with the presumption rules of paragraph (b) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d). For this purpose, a type of income is determined by the types of income required to be reported on Forms 1042-S or 1099, as appropriate. Notwithstanding the preceding sentence, deposit interest (including original issue discount) described in section 871(i)(2)(A) or 881(d) and interest or original issue discount on short-term obligations as described in section 871(g)(1)(B) or 881(e) is only required to be

allocated to the extent it is required to be reported on Form 1099 or Form 1042-S. See Sec. 1.6049-8 (regarding reporting of bank deposit interest to certain foreign persons). If a payee receives income through another nonqualified intermediary, flow-through entity, or U.S. branch described in paragraph (e)(2)(iv) of this section (other than a U.S. branch treated as a U.S. person), the withholding statement must also state, with respect to the payee, the name, address, and TIN, if known, of the other nonqualified intermediary or U.S. branch from which the payee directly receives the payment or the flow-through entity in which the payee has a direct ownership interest. If another nonqualified intermediary, flow-through entity, or U.S. branch fails to allocate a payment, the name of the nonqualified intermediary, flow-through entity, or U.S. branch that failed to allocate the payment shall be provided with respect to such payment.

(3) If a payee is identified as a foreign person, the nonqualified intermediary must specify the rate of withholding to which the payee is subject, the payee's country of residence and, if a reduced rate of withholding is claimed, the basis for that reduced rate (e.g., treaty benefit, portfolio interest, exempt under section 501(c)(3), 892, or 895). The allocation statement must also include the taxpayer identification numbers of those foreign persons for whom such a number is required under paragraph (e)(4)(vii) of this section or Sec. 1.1441-6(b)(1) (regarding claims for treaty benefits). In the case of a claim of treaty benefits, the nonqualified intermediary's withholding statement must also state whether the limitation on benefits and section 894 statements required by Sec. 1.1441-6(c)(5) have been provided, if required, in the beneficial owner's Form W-8 or associated with such owner's documentary evidence.

(4) The withholding statement must also contain any other information the withholding agent reasonably requests in order to fulfill its obligations under chapter 3, chapter 61 of the Internal Revenue Code, and section 3406.

(D) Alternative procedures.

(1) In general.

Under the alternative procedures of this paragraph (e)(3)(iv)(D), a nonqualified intermediary may provide information allocating a payment of a reportable amount to each payee (including U.S. exempt recipients) otherwise required under paragraph (e)(3)(iv)(B)(2) of this section after a payment is made. To use the alternative procedure of this paragraph (e)(3)(iv)(D), the nonqualified intermediary must inform the withholding agent on a statement associated with its nonqualified intermediary withholding certificate that it is using the procedure under this paragraph (e)(3)(iv)(D) and the withholding agent must agree to the procedure. If the requirements of the alternative procedure are met, a withholding agent, including the nonqualified intermediary using the procedures, can treat the payment as reliably associated with documentation and, therefore, the presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d) do not apply even though information allocating the payment to each payee has not been received prior to the payment. See paragraph (e)(3)(iv)(D)(7) of this section, however, for a nonqualified intermediary's liability for tax and penalties if the requirements of this paragraph (e)(3)(iv)(D) are not met. These alternative procedures shall not be used for payments that are allocable to U.S. non-exempt recipients. Therefore, a nonqualified intermediary is required to provide a withholding agent with information allocating payments of reportable amounts to U.S. non- exempt recipients prior to the payment being made by the withholding agent.

(2) Withholding rate pools.

In place of the information required in paragraph (e)(3)(iv)(C)(2) of this section allocating payments to each payee, the nonqualified intermediary must provide a withholding agent with withholding rate pool information prior to the payment of a reportable amount. The withholding statement must contain all other information required by paragraph (e)(3)(iv)(C) of this section. Further, each payee listed in the withholding statement must be assigned to an identified withholding rate pool. To the extent a nonqualified intermediary is required to, or does provide, documentation, the alternative procedures do not relieve the nonqualified intermediary from the requirement to provide

documentation prior to the payment being made. Therefore, withholding certificates or other appropriate documentation and all information required by paragraph (e)(3)(iv)(C) of this section (other than allocation information) must be provided to a withholding agent before any new payee receives a reportable amount. In addition, the withholding statement must be updated by assigning a new payee to a withholding rate pool prior to the payment of a reportable amount. A withholding rate pool is a payment of a single type of income, determined in accordance with the categories of income used to file Form 1042-S, that is subject to a single rate of withholding. A withholding rate pool may be established by any reasonable method to which the nonqualified intermediary and a withholding agent agree (e.g., by establishing a separate account for a single withholding rate pool, or by dividing a payment made to a single account into portions allocable to each withholding rate pool). The nonqualified intermediary shall determine withholding rate pools based on valid documentation or, to the extent a payment cannot be reliably associated with valid documentation, the presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d).

(3) Allocation information.

The nonqualified intermediary must provide the withholding agent with sufficient information to allocate the income in each withholding rate pool to each payee (including U.S. exempt recipients) within the pool no later than January 31 of the year following the year of payment. Any payments that are not allocated to payees for whom documentation has been provided shall be allocated to an undocumented payee in accordance with the presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d). Notwithstanding the preceding sentence, deposit interest (including original issue discount) described in section 871(i)(2)(A) or 881(d) and interest or original issue discount on short-term obligations as described in section 871(g)(1)(B) or 881(e) is not required to be allocated to a U.S. exempt recipient or a foreign payee, except as required under Sec. 1.6049-8 (regarding reporting of deposit interest paid to certain foreign persons).

(4) Failure to provide allocation information.

If a nonqualified intermediary fails to provide allocation information, if required, by January 31 for any withholding rate pool, a withholding agent shall not apply the alternative procedures of this paragraph (e)(3)(iv)(D) to any payments of reportable amounts paid after January 31 in the taxable year following the calendar year for which allocation information was not given and any subsequent taxable year. Further, the alternative procedures shall be unavailable for any other withholding rate pool even though allocation information was given for that other pool. Therefore, the withholding agent must withhold on a payment of a reportable amount in accordance with the presumption rules of paragraph (b)(3) of this section, and Secs. 1.1441-5(d) and (e)(6) and 1.6049- 5(d), unless the nonqualified intermediary provides all of the information, including information sufficient to allocate the payment to each specific payee, required by paragraph (e)(3)(iv)(A) through (C) of this section prior to the payment. A nonqualified intermediary must allocate at least 90 percent of the income required to be allocated for each withholding rate pool or the nonqualified intermediary will be treated as having failed to provide allocation information for purposes of this paragraph (e)(3)(iv)(D). See paragraph (e)(3)(iv)(D)(7) of this section for liability for tax and penalties if a nonqualified intermediary fails to provide allocation information in whole or in part.

(5) Cure provision.

A nonqualified intermediary may cure any failure to provide allocation information by providing the required allocation information to the withholding agent no later than February 14 following the calendar year of payment. If the withholding agent receives the allocation information by that date, it may apply the adjustment procedures of Sec. 1.1461-2 to any excess withholding for payments made on or after February 1 and on or before February 14. Any nonqualified intermediary that fails to cure by February 14, may request the ability to use the alternative procedures of this paragraph (e)(3)(iv)(D) by submitting a request, in writing, to the Assistant Commissioner (International). The request must state the reason that the nonqualified intermediary did not comply with the alternative procedures of this paragraph (e)(3)(iv)(D) and steps that

the nonqualified intermediary has taken, or will take, to ensure that no failures occur in the future. If the Assistant Commissioner (International) determines that the alternative procedures of this paragraph (e)(3)(iv)(D) may apply, a determination to that effect will be issued by the IRS to the nonqualified intermediary.

(6) Form 1042-S reporting in case of allocation failure.

If a nonqualified intermediary fails to provide allocation information by February 14 following the year of payment for a withholding rate pool, the withholding agent must file Forms 1042-S for payments made to each payee in that pool (other than U.S. exempt recipients) in the prior calendar year by pro rating the payment to each payee (including U.S. exempt recipients) listed in the withholding statement for that withholding rate pool. If the nonqualified intermediary fails to allocate10 percent or less of an amount required to be allocated for a withholding rate pool, a withholding agent shall report the unallocated amount as paid to a single unknown payee in accordance with the presumption rules of paragraph (b) of this section and Secs. 1.1441- 5(d) and (e)(6) and 1.6049-5(d). The portion of the payment that can be allocated to specific recipients, as defined in Sec. 1.1461- 1(c)(1)(ii), shall be reported to each recipient in accordance with the rules of Sec. 1.1461-1(c).

(7) Liability for tax, interest, and penalties.

If a nonqualified intermediary fails to provide allocation information by February 14 following the year of payment for all or a portion of the payments made to any withholding rate pool, the withholding agent from whom the nonqualified intermediary received payments of reportable amounts shall not be liable for any tax, interest, or penalties, due solely to the errors or omissions of the nonqualified intermediary. See Sec. 1.1441- 7(b)(2) through (10) for the due diligence requirements of a withholding agent. Because failure by the nonqualified intermediary to provide allocation information results in a payment not being reliably associated with valid documentation, the beneficial owners for whom the nonqualified intermediary acts are not entitled to a reduced rate of withholding. Therefore, the nonqualified intermediary, as a withholding

agent, shall be liable for any tax not withheld by the withholding agent in accordance with the presumption rules, interest on the under withheld tax if the nonqualified intermediary fails to pay the tax timely, and any applicable penalties, including the penalties under sections 6656 (failure to deposit), 6721 (failure to file information returns) and 6722 (failure to file payee statements). Failure to provide allocation information for more than 10 percent of the payments made to a particular withholding rate pool will be presumed to be an intentional failure within the meaning of sections 6721(e) and 6722(c). The nonqualified intermediary may rebut the presumption.

(8) Applicability to flow-through entities and certain U.S. branches.

See paragraph (e)(3)(v) of this section and Sec. 1.1441- 5(c)(3)(iv) and (e)(5)(iv) for the applicability of this paragraph (e)(3)(iv) to U.S. branches described in paragraph (b)(2)(iv) of this section (other than U.S. branches treated as U.S. persons) and flow- through entities.

(E) Notice procedures.

The IRS may notify a withholding agent that the alternative procedures of paragraph (e)(3)(iv)(D) of this section are not applicable to a specified nonqualified intermediary, a U.S. branch described in paragraph (b)(2)(iv) of this section, or a flow- through entity. If a withholding agent receives such a notice, it must commence withholding in accordance with the presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d) unless the nonqualified intermediary, U.S. branch, or flow-through entity complies with the procedures in paragraphs (e)(3)(iv)(A) through (C) of this section. In addition, the IRS may notify a withholding agent, in appropriate circumstances, that it must apply the presumption rules of paragraph (b)(3) of this section and Secs. 1.1441-5(d) and (e)(6) and 1.6049-5(d) to payments made to a nonqualified intermediary, a U.S. branch, or a flow-through entity even if the nonqualified intermediary, U.S. branch or flow-through entity provides allocation information prior to the payment. A withholding agent that receives a notice under this paragraph (e)(3)(iv)(E) must commence withholding in accordance with the presumption rules within 30 days of the date of the notice. The IRS may withdraw its prohibition against using the alternative procedures of paragraph (e)(3)(iv)(D) of this section, or its requirement to

follow the presumption rules, if the nonqualified intermediary, U.S. branch, or flow-through entity can demonstrate to the satisfaction of the Assistant Commissioner (International) or his delegate that it is capable of complying with the rules under chapter 3 of the Internal Revenue Code and any other conditions required by the Assistant Commissioner (International).

(v) Withholding certificate from certain U.S. branches.

A U.S. branch certificate is a withholding certificate provided by a U.S. branch described in paragraph (b)(2)(iv) of this section that is not the beneficial owner of the income. The withholding certificate is provided with respect to reportable amounts and must state that such amounts are not effectively connected with the conduct of a trade or business in the United States. The withholding certificate must either transmit the appropriate documentation for the persons for whom the branch receives the payment (i.e., as an intermediary) or be provided as evidence of its agreement with the withholding agent to be treated as a U.S. person with respect to any payment associated with the certificate. A U.S. branch withholding certificate is valid only if it is furnished on a Form W-8, an acceptable substitute form, or such other form as the IRS may prescribe, it is signed under penalties of perjury by a person authorized to sign for the branch, its validity has not expired, and it contains the information, statements, and certifications described in this paragraph (e)(3)(v). If the certificate is furnished to transmit withholding certificates and other documentation, it must contain the information, certifications, and statements described in paragraphs (e)(3)(v)(A) through (C) of this section and in paragraphs (e)(3)(iii) and (iv) (alternative procedures) of this section, applying the term U.S. branch instead of the term nonqualified intermediary. If the certificate is furnished pursuant to an agreement to treat the U.S. branch as a U.S. person, the information and certifications required on the withholding certificate are limited to the following--

(A) The name of the person of which the branch is a part and the address of the branch in the United States;

(B) A certification that the payments associated with the certificate are not effectively connected with the conduct of its trade or business in the United States; and

(C) Any other information, certifications, or statements as may be required by the form or accompanying instructions in addition to, or in lieu of, the

information and certification described in this paragraph (e)(3)(v).

(vi) Reportable amounts.

For purposes of chapter 3 of the Internal Revenue Code, a nonqualified intermediary, qualified intermediary, flow-through entity, and U.S. branch described in paragraph (b)(2)(iv) of this section (other than a U.S. branch that agrees to be treated as a U.S. person) must provide a withholding certificate and associated documentation and other information with respect to reportable amounts. For purposes of the regulations under chapter 3 of the Internal Revenue Code, the term reportable amount means an amount subject to withholding within the meaning of Sec. 1.1441-2(a), bank deposit interest (including original issue discount) and similar types of deposit interest described in section 871(i)(2)(A) or 881(d) that are from sources within the United States, and any amount of interest or original issue discount from sources within the United States on the redemption of certain short-term obligations described in section 871(g)(1)(B) or 881(e). Reportable amounts shall not include amounts received on the sale or exchange (other than a redemption) of an obligation described in section 871(g)(1)(B) or 881(e) that is effected at an office outside the United States. See Sec. 1.6045-1(g)(3) to determine whether a sale is effected at an office outside the United States. Reportable amounts also do not include payments with respect to deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, to amounts of original issue discount arising from a sale and repurchase transaction that is completed within a period of two weeks or less, or to amounts described in Sec. 1.6049-5(b)(7), (10) or (11) (relating to certain obligations issued in bearer form). While short-term OID and bank deposit interest are not subject to withholding under chapter 3 of the Internal Revenue Code, such amounts may be subject to information reporting under section 6049 if paid to a U.S. person who is not an exempt recipient described in Sec. 1.6049-4(c)(1)(ii) and to backup withholding under section 3406 in the absence of documentation. See Sec. 1.6049- 5(d)(3)(iii) for applicable procedures when such amounts are paid to a foreign intermediary.

(4) Applicable rules.

The provisions in this paragraph (e)(4) describe procedures applicable to withholding certificates on Form W-8 or Form 8233 (or a substitute form) or documentary evidence furnished to establish foreign status. These provisions do not apply to Forms W-9 (or their substitutes). For corresponding provisions regrading Form W-9 (or a substitute form), see

section 3406 and the regulations under that section.

(i) Who may sign the certificate.

A withholding certificate (or other acceptable substitute) may be signed by any person authorized to sign a declaration under penalties of perjury on behalf of the person whose name is on the certificate as provided in section 6061 and the regulations under that section (relating to who may sign generally for an individual, estate, or trust, which includes certain agents who may sign returns and other documents), section 6062 and the regulations under that section (relating to who may sign corporate returns), and section 6063 and the regulations under that section (relating to who may sign partnership returns).

(ii) Period of validity.

(A) Three-year period.

A withholding certificate described in paragraph (e)(2)(i) of this section, or a certificate described in Sec. 1.871-14(c)(2)(v) (furnished to qualify interest as portfolio interest for purposes of sections 871(h) and 881(c)), shall remain valid until the earlier of the last day of the third calendar year following the year in which the withholding certificate is signed or the day that a change in circumstances occurs that makes any information on the certificate incorrect. For example, a withholding certificate signed on September 30, 2001, remains valid through December 31, 2004, unless circumstances change that make the information on the form no longer correct. Documentary evidence described in Secs. 1.1441-6(c)(3) or (4) or 1.6049-5(c)(1) shall remain valid until the earlier of the last day of the third calendar year following the year in which the documentary evidence is provided to the withholding agent or the day that a change in circumstances occurs that makes any information on the documentary evidence incorrect.

(B) Indefinite validity period.

Notwithstanding paragraph (e)(4)(ii)(A) of this section, the following certificates or parts of certificates shall remain valid until the status of the person whose name is on the certificate is changed in a way relevant to the certificate or circumstances change that make the information on the certificate no longer correct:

(1) A withholding certificate described in paragraph (e)(2)(ii) of this section that is furnished with a TIN, provided that the withholding agent reports at least one payment annually to the beneficial owner under Sec. 1.1461-1(c) or the TIN furnished on the certificate is reported to the IRS under the procedures described in Sec. 1.1461-1(d). For example, assume a withholding agent receives a Form W-8 in 2001 from a beneficial owner with respect to an account that contains bonds, the interest on which must be reported on Form 1042-S under Sec. 1.1461-1(c). The Form W-8 contains a valid TIN and the withholding agent reports on Forms 1042-S interest to the beneficial owner for 2001 through 2005. In 2005, the beneficial owner sells some of the bonds. For purposes of the exemption from Form 1099 reporting under Sec. 1.6045-1(g), the withholding agent may consider the Form W-8 as valid, even though the payment of the sales proceeds is not reportable on Form 1042-S under Sec. 1.1461- 1(c) and even though the Form W-8 was provided more than three years previously.

(2) A certificate described in paragraph (e)(3)(ii) of this section (a qualified intermediary withholding certificate) but not including the withholding certificates, documentary evidence, statements or other information associated with the certificate.

(3) A certificate described in paragraph (e)(3)(iii) of this section (a nonqualified intermediary certificate), but not including the withholding certificates, documentary evidence, statements or other information associated with the certificate.

(4) A certificate described in paragraph (e)(3)(v) of this section (a U.S. branch withholding certificate), but not including the withholding certificates, documentary evidence, statements or other information associated with the certificate.

(5) A certificate described in Sec. 1.1441-5(c)(2)(iv) (dealing with a certificate from a person representing to be a withholding foreign partnership).

(6) A certificate described in Sec. 1.1441-5(c)(3)(iii) (a withholding certificate from a nonwithholding foreign partnership) but not including

the withholding certificates, documentary evidence, statements or other information required to be associated with the certificate.

(7) A certificate furnished by a person representing to be an integral part of a foreign government (within the meaning of Sec. 1.892-2T(a)(2)) in accordance with Sec. 1.1441-8(b), or by a person representing to be a foreign central bank of issue (within the meaning of Sec. 1.861-2(b)(4)) or the Bank for International Settlements in accordance with Sec. 1.1441-8(c)(1).

(8) A withholding certificate described in Sec. 1.1441-5(e)(5)(iii) provided by a foreign simple trust or a foreign grantor trust to transmit documentation of beneficiaries or owners, but not including the withholding certificates, documentary evidence, statements or other information associated with the certificate.

(C) Withholding certificate for effectively connected income.

Notwithstanding paragraph (e)(4)(ii)(B)(1) of this section, the period of validity of a withholding certificate furnished to a withholding agent to claim a reduced rate of withholding for income that is effectively connected with the conduct of a trade or business within the United States shall be limited to the three-year period described in paragraph (e)(4)(ii)(A) of this section.

(D) Change in circumstances.

If a change in circumstances makes any information on a certificate or other documentation incorrect, then the person whose name is on the certificate or other documentation must inform the withholding agent within 30 days of the change and furnish a new certificate or new documentation. A certificate or documentation becomes invalid from the date that the withholding agent holding the certificate or documentation knows or has reason to know that circumstances affecting the correctness of the certificate or documentation have changed. However, a withholding agent may choose to apply the provisions of paragraph (b)(3)(iv) of this section regarding the 90-day grace period as of that date while awaiting a new certificate or documentation or while seeking information regarding changes, or suspected changes, in the person's circumstances. If an intermediary (including a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that passes through certificates to a

withholding agent) or a flow-through entity becomes aware that a certificate or other appropriate documentation it has furnished to the person from whom it collects the payment is no longer valid because of a change in the circumstances of the person who issued the certificate or furnished the other appropriate documentation, then the intermediary or flow-through entity must notify the person from whom it collects the payment of the change of circumstances. It must also obtain a new withholding certificate or new appropriate documentation to replace the existing certificate or documentation whose validity has expired due to the change in circumstances. If a beneficial owner withholding certificate is used to claim foreign status only (and not, also, residence in a particular foreign country for purposes of an income tax treaty), a change of address is a change in circumstances for purposes of this paragraph (e)(4)(ii)(D) only if it changes to an address in the United States. Further, a change of address within the same foreign country is not a change in circumstances for purposes of this paragraph (e)(4)(ii)(D). A change in the circumstances affecting the withholding information provided to the withholding agent in accordance with the provisions in paragraph (e) (3)(iv) or (5)(v) of this section or in Sec. 1.1441-5(c)(3)(iv) shall terminate the validity of the withholding certificate with respect to the information that is no longer reliable unless the information is updated. A withholding agent may rely on a certificate without having to inquire into possible changes of circumstances that may affect the validity of the statement, unless it knows or has reason to know that circumstances have changed. A withholding agent may require a new certificate at any time prior to a payment, even though the withholding agent has no actual knowledge or reason to know that any information stated on the certificate has changed.

(iii) Retention of withholding certificate.

A withholding agent must retain each withholding certificate and other documentation for as long as it may be relevant to the determination of the withholding agent's tax liability under section 1461 and Sec. 1.1461-1.

(iv) Electronic transmission of information.

(A) In general.

A withholding agent may establish a system for a beneficial owner or payee to

electronically furnish a Form W-8, an acceptable substitute Form W-8, or such other form as the Internal Revenue Service may prescribe. The system must meet the requirements described in paragraph (e)(4)(iv)(B) of this section. A withholding agent may accept Forms W-8 that are furnished electronically on or after January 1, 2000, provided the requirements of paragraph (e)(4)(iv)(B) of this section are met.

(B) Requirements.

(1) In general.

The electronic system must ensure that the information received is the information sent, and must document all occasions of user access that result in the submission renewal, or modification of a Form W-8. In addition, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the person accessing the system and furnishing Form W-8 is the person named in the Form.

(2) Same information as paper Form W-8.

The electronic transmission must provide the withholding agent or payor with exactly the same information as the paper Form W-8.

(3) Perjury statement and signature requirements.

The electronic transmission must contain an electronic signature by the person whose name is on the Form W-8 and the signature must be under penalties of perjury in the manner described in this paragraph (e)(4)(iv)(B)(3).

(i) Perjury statement. The perjury statement must contain the language that appears on the paper Form W-8. The electronic system must inform the person whose name is on the Form W-8 that the person must make the declaration contained in the perjury statement and that the declaration is made by signing the Form W-8. The instructions and the language of the perjury statement must immediately follow the person's certifying statements and immediately precede the person's electronic signature.

(ii) Electronic signature. The act of the electronic signature must be effected by the person whose name is on the electronic Form W-8. The signature must also authenticate and verify the submission. For this purpose, the terms authenticate and verify have the same meanings as they do when applied to a written signature on a paper Form W-8. An electronic signature can be in any form that satisfies the foregoing requirements. The electronic signature must be the final entry in the person's Form W-8 submission.

(4) Requests for electronic Form W-8 data.

Upon request by the Internal Revenue Service during an examination, the withholding agent must supply a hard copy of the electronic Form W-8 and a statement that, to the best of the withholding agent's knowledge, the electronic Form W-8 was filed by the person whose name is on the form. The hard copy of the electronic Form W-8 must provide exactly the same information as, but need not be identical to, the paper Form W-8.

(C) Special requirements for transmission of Forms W-8 by an intermediary.

[Reserved]

(v) Electronic confirmation of taxpayer identifying number on withholding certificate.

The Commissioner may prescribe procedures in a revenue procedure (see Sec. 601.601(d)(2) of this chapter) or other appropriate guidance to require a withholding agent to confirm electronically with the IRS information concerning any TIN stated on a withholding certificate.

(vi) Acceptable substitute form.

A withholding agent may substitute its own form instead of an official Form W-8 or 8233 (or such other official form as the IRS may prescribe). Such a substitute for an official form will be acceptable if it contains provisions that are substantially similar to those of the official form, it contains the same certifications relevant to the transactions as are contained on the official form and these certifications are clearly set forth, and the substitute form includes a signature-under-penalties-of-perjury statement identical to the one stated on the official form. The substitute form is acceptable even if it does not contain all of the provisions contained on the official form, so long as it contains those

provisions that are relevant to the transaction for which it is furnished. For example, a withholding agent that pays no income for which treaty benefits are claimed may develop a substitute form that is identical to the official form, except that it does not include information regarding claim of benefits under an income tax treaty. A withholding agent who uses a substitute form must furnish instructions relevant to the substitute form only to the extent and in the manner specified in the instructions to the official form. A withholding agent may refuse to accept a certificate from a payee or beneficial owner (including the official Form W-8 or 8233) if the certificate is not provided on the acceptable substitute form provided by the withholding agent. However, a withholding agent may refuse to accept a certificate provided by a payee or beneficial owner only if the withholding agent furnishes the payee or beneficial owner with an acceptable substitute form immediately upon receipt of an unacceptable form or within 5 business days of receipt of an unacceptable form from the payee or beneficial owner. In that case, the substitute form is acceptable only if it contains a notice that the withholding agent has refused to accept the form submitted by the payee or beneficial owner and that the payee or beneficial owner must submit the acceptable form provided by the withholding agent in order for the payee or beneficial owner to be treated as having furnished the required withholding certificate.

(vii) Requirement of taxpayer identifying number.

A TIN must be stated on a withholding certificate when required by this paragraph (e)(4)(vii). A TIN is required to be stated on--

(A) A withholding certificate on which a beneficial owner is claiming the benefit of a reduced rate under an income tax treaty (other than for amounts described in Sec. 1.1441-6(c)(2);

(B) A withholding certificate on which a beneficial owner is claiming exemption from withholding because income is effectively connected with a U.S. trade or business;

(C) A withholding certificate on which a beneficial owner is claiming exemption from withholding under section 871(f) for certain annuities received under qualified plans;

(D) A withholding certificate on which a beneficial owner is claiming an exemption based solely on a foreign organization's claim of tax exempt status under section 501(c) or private foundation status (however, a TIN is not

required from a foreign private foundation that is subject to the 4-percent tax under section 4948(a) on income if that income would be exempt from withholding but for section 4948(a) (e.g., portfolio interest));

(E) A withholding certificate from a person representing to be a qualified intermediary described in paragraph (e)(5)(ii) of this section;

(F) A withholding certificate from a person representing to be a withholding foreign partnership described in Sec. 1.1441-5(c)(2)(i));

(G) A withholding certificate from a person representing to be a foreign grantor trust with 5 or fewer grantors;

(H) A withholding certificate provided by a foreign organization that is described in section 501(c);

(I) A withholding certificate from a person representing to be a U.S. branch described in paragraph (b)(2)(iv) of this section.

(viii) Reliance rules.

A withholding agent may rely on the information and certifications stated on withholding certificates or other documentation without having to inquire into the truthfulness of this information or certification, unless it has actual knowledge or reason to know that the same is untrue. In the case of amounts described in Sec. 1.1441-6(c)(2), a withholding agent described in Sec. 1.1441-7(b)(2)(ii) has reason to know that the information or certifications on a certificate are untrue only to the extent provided in Sec. 1.1441-7(b)(2)(ii). See Sec. 1.1441-6(b)(1) for reliance on representations regarding eligibility for a reduced rate under an income tax treaty. Paragraphs (e)(4)(viii) (A) and (B) of this section provide examples of such reliance.

(A) Classification.

A withholding agent may rely on the claim of entity classification indicated on the withholding certificate that it receives from or for the beneficial owner, unless it has actual knowledge or reason to know that the classification claimed is incorrect. A withholding agent may not rely on a person's claim of classification other than as a corporation if the name of the corporation indicates that the person is a per se corporation described in Sec. 301.7701-2(b)(8)(i) of this chapter unless the certificate contains a statement that the person is a

grandfathered per se corporation described in Sec. 301.7701-2(b)(8) of this chapter and that its grandfathered status has not been terminated. In the absence of reliable representation or information regarding the classification of the payee or beneficial owner, see Sec. 1.1441-1(b)(3)(ii) for applicable presumptions.

(B) Status of payee as an intermediary or as a person acting for its own account.

A withholding agent may rely on the type of certificate furnished as indicative of the payee's status as an intermediary or as an owner, unless the withholding agent has actual knowledge or reason to know otherwise. For example, a withholding agent that receives a beneficial owner withholding certificate from a foreign financial institution may treat the institution as the beneficial owner, unless it has information in its records that would indicate otherwise or the certificate contains information that is not consistent with beneficial owner status (e.g., sub-account numbers or names). If the financial institution also acts as an intermediary, the withholding agent may request that the institution furnish two certificates, i.e., a beneficial owner certificate described in paragraph (e)(2)(i) of this section for the amounts that it receives as a beneficial owner, and an intermediary withholding certificate described in paragraph (e)(3)(i) of this section for the amounts that it receives as an intermediary. In the absence of reliable representation or information regarding the status of the payee as an owner or as an intermediary, see paragraph (b)(3)(v)(A) for applicable presumptions.

(ix) Certificates to be furnished for each account unless exception applies.

Unless otherwise provided in this paragraph (e)(4)(ix), a withholding agent that is a financial institution with which a customer may open an account shall obtain withholding certificates or other appropriate documentation on an account-by-account basis.

(A) Coordinated account information system in effect.

A withholding agent may rely on the withholding certificate or other appropriate documentation furnished by a customer for a pre-existing account under any one or more of the circumstances described in this paragraph (e)(4)(ix)(A).

(1) A withholding agent may rely on documentation furnished by a

customer for another account if all such accounts are held at the same branch location.

(2) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of a universal account system that uses a customer identifier that can be used to retrieve systematically all other accounts of the customer. See Sec. 31.3406(c)-1(c)(3)(ii) and (iii)(C) of this chapter for an identical procedure for purposes of backup withholding. For purposes of this paragraph (e)(4)(ix)(A), a withholding agent is related to another person if it is related within the meaning of section 267(b) or 707(b).

(3) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of an information system other than a universal account system and the information system is described in this paragraph (e)(4)(ix)(A)(3). The system must allow the withholding agent to easily access data regarding the nature of the documentation, the information contained in the documentation, and its validity status, and must allow the withholding agent to easily transmit data into the system regarding any facts of which it becomes aware that may affect the reliability of the documentation. The withholding agent must be able to establish how and when it has accessed the data regarding the documentation and, if applicable, how and when it has transmitted data regarding any facts of which it became aware that may affect the reliability of the documentation. In addition, the withholding agent or the related party must be able to establish that any data it has transmitted to the information system has been processed and appropriate due diligence has been exercised regarding the validity of the documentation.

(4) A withholding agent may rely on documentation furnished by a beneficial owner or payee to an agent of the withholding agent. The agent may retain the documentation as part of an information system

maintained for a single or multiple withholding agents provided that the system permits any withholding agent that uses the system to easily access data regarding the nature of the documentation, the information contained in the documentation, and its validity, and must allow the withholding agent to easily transmit data into the system regarding any facts of which it becomes aware that may affect the reliability of the documentation. The withholding agent must be able to establish how and when it has accessed the data regarding the documentation and, if applicable, how and when it has transmitted data regarding any facts of which it became aware that may affect the reliability of the documentation. In addition, the withholding agent must be able to establish that any data it has transmitted to the information system has been processed and appropriate due diligence has been exercised regarding the validity of the documentation.

(B) Family of mutual funds.

An interest in a mutual fund that has a common investment advisor or common principal underwriter with other mutual funds (within the same family of funds) may, in the discretion of the mutual fund, be represented by one single withholding certificate where shares are acquired or owned in any of the funds. See Sec. 31.3406(h)-3(a)(2) of this chapter for an identical procedures for purposes of backup withholding.

(C) Special rule for brokers.

(1) In general.

A withholding agent may rely on the certification of a broker that the broker holds a valid beneficial owner withholding certificate described in paragraph (e)(2)(i) of this section or other appropriate documentation for that beneficial owner with respect to any readily tradable instrument, as defined in Sec. 31.3406(h)-1(d) of this chapter, if the broker is a United States person (including a U.S. branch treated as a U.S. person under paragraph (b)(2)(iv) of this section) that is acting as the agent of a beneficial owner and the U.S. broker has been provided a valid Form W-8 or other appropriate documentation. The certification must be in writing or in electronic form and contain all of the information required

of a nonqualified intermediary under paragraphs (e)(3)(iv)(B) and (C) of this section. If a U.S. broker chooses to use this paragraph (e)(4)(ix)(C), that U.S. broker will be solely responsible for applying the rules of Sec. 1.1441-7(b) to the withholding certificates or other appropriate documentation. For purposes of this paragraph (c)(4)(ix)(C), the term broker means a person treated as a broker under Sec. 1.6045-1(a).

(2) The following example illustrates the rules of this paragraph (e)(4)(ix)(C):

Example. SCO is a U.S. securities clearing organization that provides clearing services for correspondent broker, CB, a U.S. corporation. Pursuant to a fully disclosed clearing agreement, CB fully discloses the identity of each of its customers to SCO. Part of SCO's clearing duties include the crediting of income and gross proceeds of readily tradeable instruments (as defined in Sec. 31.3406(h)-1(d)) to each customer's account. For each disclosed customer that is a foreign beneficial owner, CB provides SCO with information required under paragraphs (e)(3)(iv)(B) and (C) of this section that is necessary to apply the correct rate of withholding and to file Forms 1042-S. SCO may use the representations and beneficial owner information provided by CB to determine the proper amount of withholding and to file Forms 1042-S. CB is responsible for determining the validity of the withholding certificates or other appropriate documentation under Sec. 1.1441-1(b).

(5) Qualified intermediaries.

(i) General rule.

A qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, may furnish a qualified intermediary withholding certificate to a withholding agent. The withholding certificate provides certifications on behalf of other persons for the purpose of claiming and verifying reduced rates of withholding under section 1441 or 1442 and for the purpose of reporting and withholding under other provisions of the Internal Revenue Code, such as the provisions under chapter 61 and section 3406 (and the regulations under those provisions). Furnishing such a certificate is in lieu of transmitting to a

withholding agent withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment, including interest holders in a qualified intermediary that is fiscally transparent under the regulations under section 894. Although the qualified intermediary is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or interest holders pursuant to its agreement with the IRS, it is generally not required to attach such documentation to the intermediary withholding certificate. Notwithstanding the preceding sentence a qualified intermediary must provide a withholding agent with the Forms W-9, or disclose the names, addresses, and taxpayer identifying numbers, if known, of those U.S. non-exempt recipients for whom the qualified intermediary receives reportable amounts (within the meaning of paragraph (e)(3)(vi) of this section) to the extent required in the qualified intermediary's agreement with the IRS. A person may claim qualified intermediary status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may prescribe.

(ii) Definition of qualified intermediary.

With respect to a payment to a foreign person, the term qualified intermediary means a person that is a party to a withholding agreement with the IRS and such person is--

(A) A foreign financial institution or a foreign clearing organization (as defined in Sec. 1.163-5(c)(2)(i)(D)(8), without regard to the requirement that the organization hold obligations for members), other than a U.S. branch or U.S. office of such institution or organization;

(B) A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization (as defined in Sec. 1.163-5(c)(2)(i)(D)(8), without regard to the requirement that the organization hold obligations for members);

(C) A foreign corporation for purposes of presenting claims of benefits under an income tax treaty on behalf of its shareholders; or

(D) Any other person acceptable to the IRS.

(iii) Withholding agreement.

(A) In general.

The IRS may, upon request, enter into a withholding agreement with a foreign person described in paragraph (e)(5)(ii) of this section pursuant to such procedures as the IRS may prescribe in published guidance (see Sec. 601.601(d)(2) of this chapter). Under the withholding agreement, a qualified intermediary shall generally be subject to the applicable withholding and reporting provisions applicable to withholding agents and payors under chapters 3 and 61 of the Internal Revenue Code, section 3406, the regulations under those provisions, and other withholding provisions of the Internal Revenue Code, except to the extent provided under the agreement.

(B) Terms of the withholding agreement.

Generally, the agreement shall specify the type of certifications and documentation upon which the qualified intermediary may rely to ascertain the classification (e.g., corporation or partnership) and status (i.e., U.S. or foreign) of beneficial owners and payees who receive payments collected by the qualified intermediary and, if necessary, entitlement to the benefits of a reduced rate under an income tax treaty. The agreement shall specify if, and to what extent, the qualified intermediary may assume primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section. It shall also specify the extent to which applicable return filing and information reporting requirements are modified so that, in appropriate cases, the qualified intermediary may report payments to the IRS on an aggregated basis, without having to disclose the identity of beneficial owners and payees. However, the qualified intermediary may be required to provide to the IRS the name and address of those foreign customers who benefit from a reduced rate under an income tax treaty pursuant to the qualified intermediary arrangement for purposes of verifying entitlement to such benefits, particularly under an applicable limitation on benefits provision. Under the agreement, a qualified intermediary may agree to act as an acceptance agent to perform the duties described in Sec. 301.6109-1(d)(3)(iv)(A) of this chapter. The agreement may specify the manner in which applicable procedures for adjustments for underwithholding and overwithholding, including refund procedures, apply in the context of a qualified intermediary arrangement and the extent to which applicable procedures may be modified. In particular, a withholding agreement may allow a qualified intermediary to claim refunds of overwithheld amounts. If relevant, the agreement shall specify the manner in which the qualified intermediary may deal

with payments to other intermediaries and flow-through entities. In addition, the agreement shall specify the manner in which the IRS will verify compliance with the agreement. In appropriate cases, the IRS may agree to rely on audits performed by an intermediary's approved auditor. In such a case, the IRS's audit may be limited to the audit of the auditor's records (including work papers of the auditor and reports prepared by the auditor indicating the methodology employed to verify the entity's compliance with the agreement). For this purpose, the agreement shall specify the auditor or class of auditors that are approved. Generally, an auditor will not be approved if the auditor is not subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to perform the audit competently. The agreement may include provisions for the assessment and collection of tax in the event that failure to comply with the terms of the agreement results in the failure by the withholding agent or the qualified intermediary to withhold and deposit the required amount of tax. Further, the agreement may specify the procedures by which deposits of amounts withheld are to be deposited, if different from the deposit procedures under the Internal Revenue Code and applicable regulations. To determine whether to enter a qualified intermediary withholding agreement and the terms of any particular withholding agreement, the IRS will consider appropriate factors including whether or not the foreign person agrees to assume primary withholding responsibility, the type of local know-your-customer laws and practices to which it is subject, the extent and nature of supervisory and regulatory control exercised under the laws of the foreign country over the foreign person, the volume of investments in U.S. securities (determined in dollar amounts and number of account holders), the financial condition of the foreign person, and whether the qualified intermediary is a resident of a country with which the United States has an income tax treaty.

(iv) Assignment of primary withholding responsibility.

Any person who meets the definition of a withholding agent under Sec. 1.1441-7(a) (whether a U.S. person or a foreign person) is required to withhold and deposit any amount withheld under Sec. 1.1461-1(a) and to make the returns prescribed by Sec. 1.1461-1(b) and (c). If permitted by its qualified intermediary agreement, a qualified intermediary agreement may, however, inform a withholding agent from which it receives a payment that it will assume the primary obligation to withhold, deposit, and report amounts under chapter 3 of the Internal Revenue Code and/or under chapter 61

of the Internal Revenue Code and section 3406. If a withholding agent makes a payment of an amount subject to withholding, as defined in Sec. 1.1441-2(a), or a reportable payment, as defined in section 3406(b), to a qualified intermediary that represents to the withholding agent that it has assumed primary withholding responsibility for the payment, the withholding agent is not required to withhold on the payment. The withholding agent is not required to determine that the qualified intermediary agreement actually permits the qualified intermediary to assume primary withholding responsibility. A qualified intermediary that assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code or primary reporting and backup withholding responsibility under chapter 61 and section 3406 is not required to assume primary withholding responsibility for all accounts it has with a withholding agent but must assume primary withholding responsibility for all payments made to any one account that it has with the withholding agent. A qualified intermediary may agree with the withholding agent to assume primary withholding responsibility under chapter 3 and section 3406, only if expressly permitted to do so under its agreement with the IRS.

(v) Withholding statement.

(A) In general.

A qualified intermediary must provide each withholding agent from which it receives reportable amounts, as defined in paragraph (e)(3)(vi) of this section, as a qualified intermediary with a written statement (the withholding statement) containing the information specified in paragraph (e)(5)(v)(B) of this section. A withholding statement is not required, however, if all of the information a withholding agent needs to fulfill its withholding and reporting requirements is contained in the withholding certificate. The qualified intermediary agreement may require, in appropriate circumstances, the qualified intermediary to include information in its withholding statement relating to payments other than payments of reportable amounts. The withholding statement forms an integral part of the qualified intermediary's qualified intermediary withholding certificate and the penalties of perjury statement provided on the withholding certificate shall apply to the withholding statement as well. The withholding statement may be provided in any manner, and in any form, to which qualified intermediary and the withholding agent mutually agree, including electronically. If the withholding statement is provided electronically, there must be sufficient safeguards to ensure that the information received by the withholding agent is the information sent by qualified intermediary and must also document all occasions of user

access that result in the submission or modification of withholding statement information. In addition, the electronic system must be capable of providing a hard copy of all withholding statements provided by the qualified intermediary. The withholding statement shall be updated as often as necessary for the withholding agent to meet its reporting and withholding obligations under chapters 3 and 61 of the Internal Revenue Code and section 3406. A withholding agent will be liable for tax, interest, and penalties in accordance with paragraph (b)(7) of this section to the extent it does not follow the presumption rules of paragraph (b)(3) of this section, Secs. 1.1441-5(d) and (e)(6), and 1.6049-5(d) for any payment, or portion thereof, for which it does not have a valid withholding statement prior to making a payment.

(B) Content of withholding statement.

The withholding statement must contain sufficient information for a withholding agent to apply the correct rate of withholding on payments from the accounts identified on the statement and to properly report such payments on Forms 1042-S and Forms 1099, as applicable. The withholding statement must--

(1) Designate those accounts for which the qualified intermediary acts as a qualified intermediary;

(2) Designate those accounts for which qualified intermediary assumes primary withholding responsibility under chapter 3 of the Internal Revenue Code and/or primary reporting and backup withholding responsibility under chapter 61 and section 3406; and (3) Provide information regarding withholding rate pools, as described in paragraph (e)(5)(v)(C) of this section.

(C) Withholding rate pools.

(1) In general.

Except to the extent it has assumed both primary withholding responsibility under chapter 3 of the Internal Revenue Code and primary reporting and backup withholding responsibility under chapter 61 and section 3406 with respect to a payment, a qualified intermediary shall provide as part of its withholding statement the withholding rate pool information that is required for the withholding agent to meet its

withholding and reporting obligations under chapters 3 and 61 of the Internal Revenue Code and section 3406. A withholding rate pool is a payment of a single type of income, determined in accordance with the categories of income reported on Form 1042-S or Form 1099, as applicable, that is subject to a single rate of withholding. A withholding rate pool may be established by any reasonable method on which the qualified intermediary and a withholding agent agree (e.g., by establishing a separate account for a single withholding rate pool, or by dividing a payment made to a single account into portions allocable to each withholding rate pool). To the extent a qualified intermediary does not assume primary reporting and backup withholding responsibility under chapter 61 and section 3406, a qualified intermediary's withholding statement must establish a separate withholding rate pool for each U.S. non-exempt recipient account holder that the qualified intermediary has disclosed to the withholding agent unless the qualified intermediary uses the alternative procedures in paragraph (e)(5)(v)(C)(2) of this section. A qualified intermediary shall determine withholding rate pools based on valid documentation that it obtains under its withholding agreement with the IRS, or if a payment cannot be reliably associated with valid documentation, under the applicable presumption rules. If a qualified intermediary has an account holder that is another intermediary (whether a qualified intermediary or a nonqualified intermediary) or a flow-through entity, the qualified intermediary may combine the account holder information provided by the intermediary or flow-through entity with the qualified intermediary's direct account holder information to determine the qualified intermediary's withholding rate pools.

(2) Alternative procedure for U.S. non-exempt recipients.

If permitted under its agreement with the IRS, a qualified intermediary may, by mutual agreement with a withholding agent, establish a single zero withholding rate pool that includes U.S. non-exempt recipient account holders for whom the qualified intermediary has provided Forms W-9 prior to the withholding agent paying any reportable payments, as defined in the qualified intermediary agreement, and a separate withholding rate pool (subject to 31-percent withholding) that

includes only U.S. non-exempt recipient account holders for whom a qualified intermediary has not provided Forms W-9 prior to the withholding agent paying any reportable payments. If a qualified intermediary chooses the alternative procedure of this paragraph (e)(5)(v)(C)(2), the qualified intermediary must provide the information required by its qualified intermediary agreement to the withholding agent no later than January 15 of the year following the year in which the payments are paid. Failure to provide such information will result in the application of penalties to the qualified intermediary under sections 6721 and 6722, as well as any other applicable penalties, and may result in the termination of the qualified intermediary's withholding agreement with the IRS. A withholding agent shall not be liable for tax, interest, or penalties for failure to backup withhold or report information under chapter 61 of the Internal Revenue Code due solely to the errors or omissions of the qualified intermediary. If a qualified intermediary fails to provide the allocation information required by this paragraph (e)(5)(v)(C)(2), with respect to U.S. non-exempt recipients, the withholding agent shall report the unallocated amount paid from the withholding rate pool to an unknown recipient, or otherwise in accordance with the appropriate Form 1099 and the instructions accompanying the form.

(f) Effective date.

(1) In general.

This section applies to payments made after December 31, 2000.

(2) Transition rules.

(i) Special rules for existing documentation.

For purposes of paragraphs (d)(3) and (e)(2)(i) of this section, the validity of a withholding certificate (namely, Form W-8, 8233, 1001, 4224, or 1078 , or a statement described in Sec. 1.1441-5 in effect prior to January 1, 2001 (see Sec. 1.1441-5 as contained in 26 CFR part 1, revised April 1, 1999)) that was valid on January 1, 1998 under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) and expired, or will expire, at any time during 1998, is extended until December 31, 1998. The validity of a withholding certificate that

is valid on or after January 1, 1999, remains valid until its validity expires under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) but in no event will such withholding certificate remain valid after December 31, 2001. The rule in this paragraph (f)(2)(i), however, does not apply to extend the validity period of a withholding certificate that expires solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the first three sentences of this paragraph (f)(2)(i), a withholding agent may choose to not take advantage of the transition rule in this paragraph (f)(2)(i) with respect to one or more withholding certificates valid under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999) and, therefore, to require withholding certificates conforming to the requirements described in this section (new withholding certificates). For purposes of this section, a new withholding certificate is deemed to satisfy the documentation requirement under the regulations in effect prior to January 1, 2001 (see 26 CFR parts 1 and 35a, revised April 1, 1999). Further, a new withholding certificate remains valid for the period specified in paragraph (e)(4)(ii) of this section, regardless of when the certificate is obtained.

(ii) Lack of documentation for past years.

A taxpayer may elect to apply the provisions of paragraphs (b)(7)(i)(B), (ii), and (iii) of this section, dealing with liability for failure to obtain documentation timely, to all of its open tax years, including tax years that are currently under examination by the IRS. The election is made by simply taking action under those provisions in the same manner as the taxpayer would take action for payments made after December 31, 2000.

[T.D. 7385, 40 FR 50263, Oct. 29, 1975, as amended by T.D. 7670, 45 FR 6932, Jan. 31, 1980; T.D. 8734, 62 FR 53387, October 14, 1997, not effective until January 1, 1999; T.D. 8804, Federal Register: December 31, 1998 (Volume 63, Number 251), Page 72183-72189; T.D.8856, Federal Register: December 30, 1999 (Volume 64, Number 250), Page 73408-73413; T.D. 8881, Federal Register: May 22, 2000 (Volume 65, Number 99), Page 32151-32212; corrected by T.D. 8881, Federal Register: April 6, 2001 (Volume 66, Number 67), Page 18187-18190]

Code **Sec. 31.3401(c)-1 Employee.**

(a) The term EMPLOYEE includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and

employee. The term includes officers and employees, whether elected or appointed, of the United States, a State, Territory, Puerto Rico, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

(b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

(c) Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees.

(d) Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case.

(e) If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

(f) All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.

(g) The term EMPLOYEE includes every individual who receives a supplemental unemployment compensation benefit which is treated under paragraph (b)(14) of Section 31.3401(a)-1 as if it

were wages.

(h) Although an individual may be an employee under this section, his services may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 3401(a).

[T.D. 6516, 25 FR 13096, Dec. 20, 1960, as amended by T.D. 7068, 35 FR 17329, Nov. 11, 1970]

U.S. Supreme Court

BUTCHERS' UNION CO. v. CRESCENT CITY CO., 111 U.S. 746 (1884)

111 U.S. 746

BUTCHERS' UNION SLAUGHTER-HOUSE & LIVE-STOCK LANDING CO.
v.
CRESCENT city live-stock landing & SLAUGHTER-HOUSE CO. 1

May 5, 1884

B. R. Forman, for appellant.

Thos. J. Semmes, for appellee.

MILLER, J.

This is an appeal from the circuit court for the Eastern district of Louisiana. The appellee brought a suit in the circuit court to obtain an injunction against the appellant forbidding the latter from ex- [111 U.S. 746, 747] ercising the business of butchering, or receiving and landing live-stock intended for butchering, within certain limits in the parishes of Orleans, Jefferson, and St. Bernard, and obtained such injuction by a final decree in that court. He ground on which this suit was brought and sustained is that the plaintiffs had the exclusive right to have all such stock landed at their stock landing-place, and butchered at their slaughter-house, by virtue of an act of the general assembly of Louisiana, approved March 8, 1869, entitled 'An act to protect the health of the city of New Orleans, to locate the stock landing and slaughterhouses, and to incorporate the Crescent City Live-stock Landing & Slaughter-house Company.' An examination of that statute, especially of its fourth and fifth sections, leaves no doubt that it did grant such an exclusive right. The fact that it did so, and that this was conceded, was the basis of the contest in this court in the slaughter-house Cases, 16 Wall. 36, in which the law was

assailed as a monopoly forbidden by the thirteenth and fourteenth amendments to the constitution of the United States, and these amendments, as well as the fifteenth, came for the first time before this court for construction. The constitutional power of the state be enact the statute was upheld by this court. This power was placed by the court in that case expressly on the ground that it was the exercise of the police power which had remained with the states in the formation of the original constitution of the United States, and had not been taken away by the amendments adopted since. Citing the definition of this power from Chancellor KENT, it declares that the statute in question came within it. 'Unwholesome trades, slaughter-houses, operations offensive to the senses, the deposit of powder, the application of steam-power to propel cars, the building with combustible materials, and the burial of the dead, may all (he says) be interdicted by law in the midst of dense masses of population, on the general and rational principle that every person ought so to use his property as not to injure his neighbors; and that private interests must be made subservient to the general interest of the community.' [111 U.S. 746, 748] 2 Kent, Comm. 340; 16 Wall. 62. In this latter case it was added that 'the regulation of the place and manner of conducting the slaughtering of animals, and the business of butchering within a city, and the inspection of the animals to be killed for meat, and of the meat afterwards, are among the most necessary and frequent exercises of this power.'

But in the year 1879 the state of Louisiana adopted a new constitution, in which were the following articles:

> 'Art. 248. The police juries of the several parishes, and the constituted authorities of all incorporated municipalities of the state, shall alone have the power of regulating the slaughtering of cattle and other live-stock within their respective limits: Provided, no monopoly or exclusive privilege shall exist in this state, nor such business be restricted to the land or houses of any individual or corporation: provided, the ordinances designating places for slaughtering shall obtain the concurrent approval of the board of health or other sanitary organization.'
>
> 'Art. 258. ... The monopoly features in the charter of any corporation now existing in the state, save such as may be contained in the charters of railroad companies, are hereby abolished.'

Under the authority of these articles of the constitution the municipal authorities of the city of New Orleans enacted ordinances which opened to general competition the right to build slaughter-houses, establish stock landings, and engage in the business of butchering in that city under regulations established by those ordinances, but which were in utter disregard of the monopoly granted to the Crescent City Company, and which in effect repealed the exclusive grant made to that company by the act of 1869. The appellant here, the Butchers' Union Slaughter-house Company, availing themselves of this repeal, entered upon the business, or were about to do so, by establishing their slaughter-house and stock landing within the limits of the grant of the act of 1869 to the Crescent City Company. Both these corporations, organized under the laws of Louisiana and doing business in that state, were citizens of the same [111 U.S. 746, 749] state, and could not, in respect of that citizenship, sue each other in a court of the United States. The Crescent City Company, however, on the allegation that these constitutional provisions of 1879, and the subsequent ordinances of the city, were a violation of their contract with the state under the act of 1869, brought this suit in the circuit court as arising under the constitution of the United States, art. 1, 10. That court sustained the view of the plaintiff below, and held that the act of 1869, and the acceptance of it by the Crescent City Company, constituted a contract for the exclusive right mentioned in it for 25 years; that it was within the power of the legislature of Louisiana to make that contract, and as the constitutional provisions of 1879 and the subsequent ordinances of the city impaired its obligation, they were to that extent void. No one can examine the provisions of the act of 1869, with the knowledge that they were accepted by the Cresecent City Company, and so far acted on that a very large amount of money was expended in a vast slaughter-house, and an equally extensive

stock-yard and landing-place, and hesitate to pronounce that in form they have all the elements of a contract on sufficient consideration. It admits of as little doubt that the ordinance of the city of New Orleans, under the new constitution, impaired the supposed obligation imposed by those provisions on the state, by taking away the exclusive right of the company granted to it for 25 years, which was to the company the most valuable thing supposed to be secured to it by the statutory contract. We do not think it necessary to spend time in demonstrating either of these propositions. We do not believe they will be controverted.

The appellant, however, insists that, so far as the act of 1869 partakes of the nature of an irrepealable contract, the legislature exceeded its authority, and it had no power to tie the hands of the legislature in the future from legislating on that subject without being bound by the terms of the statute then enacted. This proposition presents the real point in the case. [111 U.S. 746, 750] Let us see clearly what it is. It does not deny the power of that legislature to create a corporation, with power to do the business of landing live-stock and providing a place for slaughtering them in the city. It does not deny the power to locate the place where this shall be done exclusively. It does not deny even the power to give an exclusive right, for the time being, to particular persons or to a corporation to provide this stock landing and to establish this slaughter-house. But it does deny the power of that legislature to continue this right so that no future legislature, nor even the same body, can repeal or modify it, or grant similar privileges to others. It concedes that such a law, so long as it remains on the statute-book as the latest expression of the legislative will, is a valid law, and must be obeyed, which is all that was decided by this court in the Slaughter-house Cases. But it asserts the right of the legislature to repeal such a statute, or to make a new one inconsistent with it, whenever, in the wisdom of such legislature, it is for the good of the public it should be done. Nor does this proposition contravene the established principle that the legislature of a state may make contracts on many subjects which will bind it, and will bind succeeding legislatures for the time the contract has to run, so that its provisions can neither be repealed nor its obligation impaired. The examples are numerous where this has been done and the contract upheld. The denial of this power, in the present instance, rests upon the ground that the power of the legislature intended to be suspended is one so indispensable to the public welfare that it cannot be bargained away by contract. It is that well- known but undefined power called the police power. We have not found a better definition of it for our present purpose than the extract from Kent's Commentaries in the earlier part of this opinion. 'The power to regulate unwholesame trades, slaughter-houses, operations offensive to the senses,' there mentioned, point unmistakably to the powers exercised by the act of 1869, and the ordinances of the city under the constitution of 1879. While we are not prepared to say that the legislature can make [111 U.S. 746, 751] valid contracts on no subject embraced in the largest definition of the police power, we think that, in regard to two subjects so embraced, it cannot, by any contract, limit the exercise of those powers to the prejudice of the general welfare. These are the public health and public morals. The preservation of these is so necessary to the best interests of social organization, that a wise policy forbids the legislative body to divest itself of the power to enact laws for the preservation of health and the repression of crime.

It cannot be permitted that, when the constitution of a state, the fundamental law of the land, has imposed upon its legislature the duty of guarding, by suitable laws, the health of its citizens, especially in crowded cities, and the protection of their person and property by suppressing and preventing crime, that the power which enables it to perform this duty can be sold, bargained away, under any circumstances, as if it were a mere privilege which the legislator could dispose of at his pleasure. This principle has been asserted and repeated in this court in the last few years in no ambiguous terms. The first time it seems to have been distinctly and clearly presented was in the case of Boyd v. Alabama, 94 U.S. 646 . That was a writ of error to the supreme court of Alabama, brought by Boyd, who had been convicted in the courts of that state of carrying on a lottery contrary to law. In his defense, he relied upon a statute which authorized lotteries for a specific purpose, under which he held a license. The repeal of this statute, which made his license of no avail against the general law forbidding lotteries,

was asserted by his counsel to be void as impairing the obligation of the contract, of which his license was evidence, and the supreme court of Alabama had in a previous case held it to be a contract. In Boyd's Case, however, that court held the law under which his license was issued to be void, because the object of it was not expressed in the title as required by the constitution of the state. This court followed that decision, and affirmed the judgment on that ground. But in the concluding sentences of the opinion by Mr. Jus- [111 U.S. 746, 752] tice FIELD, the court, to repel the inference that the contract would have been irrepealable if the statute had conformed to the special requirement of the constitution, said: 'We are not prepared to admit that it is competent for one legislature, by any contract with an individual, to restrain the power of a subsequent legislature to legislate for t e public welfare, and to that end to suppress any and all practices tending to corrupt the public morals,' citing Moore v. State, 48 Miss. 147, and Metropolitan Board of Excise v. Barrie, 34 N. Y. 663. This cautionary declaration received the unanimous concurrence of the court, and a year later the principle became the foundation of the decision in the case of Beer Co. v. Massachusetts, 97 U.S. 28 . In that case the plaintiff in error, the Boston Beer Company, had been chartered in 1828 with a right to manufacture beer, which this court held to imply the right to sell it. Subsequent statutes of a prohibitory character seemed to interfere with this right, and the case was brought to this court on the ground that they impaired the obligation of the contract of the charter. But the court, speaking by Justice BRADLEY, held that, on this subject, the legislature of Massachusetts could make no irrepealable contract. 'Whatever differences of opinion,' said the court, 'may exist as to the extent and boundaries of the police power, and however difficult it may be to render a satisfactory definition of it, there seems to be no doubt that it does extend to the protection of the lives, health, and property of the citizens, and to the preservation of good order and public morals. The legislature cannot by any contract divest itself of the power to provide for these objects. They belong emphatically to that class of objects which demand the application of the maxim, salus populi suprema lex, and they are to be attained and provided for by such appropriate means as the legislative discretion may devise. That discretion can no more be bargained away than the power itself.'

In the still more recent case of Stone v. Mississippi, 101 U.S. 814 , the whole subject is reviewed in the opinion deliv- [111 U.S. 746, 753] ered by the chief justice. That also was a case of a chartered lottery, whose charter was repealed by a constitution of the state subsequently adopted. It came here for relief, relying on the clause of the federal constitution against impairing the obligation of contracts. 'The question is therefore presented, (says the opinion,) whether, in view of these facts, the legislature of a state can, by the charter of a lottery company, defeat the will of the people authoritatively expressed, in relation to the further continuance of such business in their midst. We think it cannot. No legislature can bargain away the public health or the public morals. The people themselves cannot do it, much less their servants. The supervision of both these subjects of governmental power is continuing in its nature, and they are to be dealt with as the special exigencies of the moment may require. Government is organized with a view to their preservation, and cannot divest itself of the power to provide for them. For this purpose the legislative discretion is allowed, and the discretion cannot be parted with any more than the power itself.'

But the case of the Fertilizing Co. v. Hyde Park, 97 U.S. 659 , is, perhaps, more directly in point as regard the facts of the case, while asserting the same principle. The Fertilizing Company was chartered by the Illinois legislature for the purpose of converting, by chemical processes, the dead animal matter of the slaughter-houses of the city of Chicago into a fertilizing material. Some ordinances of the village of Hyde Park, through wich this dead matter was carried to their chemical works, were supposed to impair the rights of contract conferred by the charter. The opinion cites the language of the court in Beer Co. v. Massachusetts, supra, and numerous other cases, of the exercise of the police power in protecting health and property, and holds that the charter conferred no irrepealable right for the 50 years of its duration to continue a practice injurious to the public health.

These cases are cited, and their views adopted in the opinion of the supreme court of Louisiana, in a suit

between the same parties, in regard to the same matter as the present [111 U.S. 746, 754] case, and which was brought to this court by writ of error, and dismissed before a hearing by the present appellee.

The result of these considerations is that the constitution of 1879, and the ordinances of the city of New Orleans which are complained of, are not void as impairing the obligation of complainant's contract, and that the decree of the circuit court must be reversed, and the case remanded to that court, with directions to dismiss the bill.

FIELD, J., concurring.

I concur in the doctrine declared in the opinion of the court, that the legislature cannot, by contract with an individual or corporation, restrain, diminish, or surrender its power to enact laws for the preservation of the public health or the protection of the public morals. This is a principle of vital importance, and its habitual observance is essential to the wise and valid execution of the trust committed to the legislature. But there are some provisions in the act of Louisiana upon which the appellees rely that have not been referred to, and which, from the interest excited by the decision rendered when that act was before us in the Slaughter-house Cases, should be mentioned in connection with the views now expressed. 16 Wall. 36. No one of the judges who then disagreed with the majority of the court denied that the states possessed the fullest power ever claimed by the most earnest advocate of their reserved rights, to prescribe regulations affecting the health, the good order, the morals, the peace, and the safety of society within their respective limits. When such regulations do not conflict with any constitutional inhibition or natural right, their validity cannot be successfully controverted. The general government was not formed to interfere with or control them. No aid was required from any external authority for their enforcement. It was only for matters which concerned all the states, and which could not be efficiently or advantageously managed by them separately, that a general and common government was desired. And the recent amendments to the constitution have not changed nor diminished their previously existing [111 U.S. 746, 755] power to legislate respecting the public health and public morals. But though this power rests with them, it cannot be admitted that, under the pretense of providing for the public health or public morals, they can encroach upon rights which those amendments declare shall not be impaired. The act of Louisiana required that the slaughtering of cattle and the preparation of animal food for market should be done outside of the limits of the city of New Orleans. It was competent to make this requirement, and, furthermore, to direct that the animals, before being slaughtered, should be inspected, in order to determine whether they were in a fit condition to be prepared for food. The dissenting judges in the Slaughte -house Cases found no fault with these provisions, but, on the contrary, approved of them. Had the act been limited to them, there would have been no dissent from the opinion of the majority. But it went a great way beyond them. It created a corporation, and gave to it an exclusive right for 25 years to keep, within an area of 1,145 square miles, a place where alone animals intended for slaughter could be landed and sheltered, and where alone they could be slaughtered and their meat prepared for market. It is difficult to understand how in a district embracing a population of a quarter of a million, any conditions of health can require that the preparation of animal food should be intrusted to a single corporation for 25 years, or how in a district of such extent there can be only one place in which animals can, with safety to the public health, be sheltered and slaughtered. In the grant of these exclusive privileges a monopoly of an ordinary employment and business was created. A monopoly is defined 'to be an institution or allowance from the sovereign power of the state, by grant, commission, or otherwise, to any person or corporation, for the sole buying, selling, making, working, or using of anything whereby any person or persons, bodies politic or corporate, are sought to be restrained of any freedom or liberty they had before or hindered in their lawful trade,' All grants of this kind are void at common law, because they destroy the freedom of trade, discourage labor and industry, restrain persons from getting an [111 U.S. 746, 756] honest livelihood, and put it in the power of the grantees to enhance the price of commodities. They are void because they interfere with the liberty of the individual to pursue a lawful trade or employment.

The oppressive nature of the principle upon which the monopoly here was granted will more clearly appear if it be applied to other vocations than that of keeping cattle and of preparing animal food for market,-to the ordinary trades and callings of life,-to the making of bread, the raising of vegetables, the manufacture of shoes and hats, and other articles of daily use. The granting of an exclusive right to engage in such vocations would be repudiated in all communities as an invasion of common right. The state undoubtedly may require many kinds of business to be carried on beyond the thickly settled portions of a city, or even entirely without its limits, especially when attendant odors or noises affect the health or disturb the peace of the neighborhood; but the exercise of this necessary power does not warrant granting to a particular class or to a corporation a monopoly of the business thus removed. It may be that, for the health or safety of a city, the manufacture of beer, or soap, or the smelting of ores, or the casting of machinery should be carried on without its limits, yet it would hardly be contended that the power thus to remove the business beyond certain limits would authorize the granting of a monopoly of it to any one or more persons. And if not a monopoly in business of this character, how can a monopoly for like reasons be granted in the business of preparing animal food for market, or of yarding and sheltering cattle intended for slaughter?

As in our intercourse with our fellow-men certain principles of morality are assumed to exist, without which society would be impossible, so certain inherent rights lie at the foundation of all action, and upon a recognition of them alone can free institutions be maintained. These inherent rights have never been more happily expressed than in the declaration of independence, that new evangel of liberty to the people: 'We hold these truths to be self-evident'-that is, so plain that their truth is recognized upon their mere statement-'that all men are [111 U.S. 746, 757] endowed'-not by edicts of emperors, or deerees of parliament, or acts of congress, but 'by their Creator with certain inalienable rights.'-that is, rights which cannot be bartered away, or given away, or taken away, except in punishment of crime-'and tha among these are life, liberty, and the pursuit of happiness; and to secure these'-not grant them, but secure them-'governments are instituted among men, deriving their just powers from the consent of the governed.' Among these inalienable rights, as proclaimed in that great document, is the right of men to pursue their happiness, by which is meant the right to pursue any lawful business or vocation, in any manner not inconsistent with the equal rights of others, which may increase their prosperity or develop their faculties, so as to give to them their highest enjoyment. The common business and callings of life, the ordinary trades and pursuits, which are innocuous in themselves, and have been followed in all communities from time immemorial, must therefore be free in this country to all alike upon the same conditions. The right to pursue them, without let or hinderance, except that which is applied to all persons of the same age, sex, and condition, is a distinguishing privilege of citizens of the United States, and an essential element of that freedom which they claim as their birthright. It has been well said that 'the property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable. The patrimony of the poor man lies in the strength and dexterity of his own hands, and to hinder his employing this strength and dexterity in what manner he thinks proper, without injury to his neighbor, is a plain violation of this most sacred property. It is a manifest encroachment upon the just liberty both of the workman and of those who might be disposed to employ him. As it hinders the one from working at what he thinks proper, so it hinders the others from employing whom they think proper.' Smith, Wealth Nat. bk. 1, c. 10.

In this country it has seldom been held, and never in so odious a form as is here claimed, that an entire trade and busi- [111 U.S. 746, 758] ness could be taken from citizens and vested in a single corporation. Such legislation has been regarded everywhere else as inconsistent with civil liberty. That exists only where every individual has the power to pursue his own happiness according to his own views, unrestrained except by equal, just, and impartial laws. The act of Lousiana compelled more than a thousand persons to abandon their regular business, and to surrender it to a corporation to which was given an exclusive right to pursue it for 25 years. What was lawful to these thousand persons the day before the law took effect was unlawful the day afterwards. With what intense indignation would a law

be regarded that should, in like manner, turn over the common trades of the community to a single corporation. I cannot believe that what is termed in the declaration of independence a Godgiven and an inalienable right can be thus ruthlessly taken from the citizen, or that there can be any abridgment of that right except by regulations alike affecting all persons of the same age, sex, and condition. It cannot be that a state may limit to a specified number of its people the right to practice law, the right to practice medicine, the right to preach the gospel, the right to till the soil, or to pursue particular business or trades, and thus parcel out to different parties the various vocations and callings of life. The first section of the fourteenth amendment was, among other things, designed to prevent all discriminating legislation for the benefit of some to the disparagement of others; and when rightly enforced as other prohibitions upon the state, not by legislation of a penal nature, but through the courts, no one will complain. The disfranchising provisions of the third section naturally created great hostility to the whole amendment. They were regarded by many wise and good men as impolitic, harsh, and cruel; and the manner in which the first section has been enforced by penal enactments against legislators and governors has engendered wide-spread and earnest hostility to it. Communities, like individuals, resent even fa ors ungraciously bestowed. The appropriate mode of enforcing the amendment is, in my judgment, that which has been applied to other previously existing constitutional prohibitions, such as the one against a state pass- [111 U.S. 746, 759] ing a law impairing the obligation of contracts, or a bill of attainder, or an ex post facto law. The only provisions deemed necessary to annul legislation of this kind have been such as facilitated proceedings for that purpose in the courts; no other can be appropriate against the action of a state. Thus enforced, there would be little objection to the provisions of the first section of the amendment. No one would object to the clause forbidding a state to abridge the privileges and immunities of citizen of the United States; that is, to take away or impair their fundamental rights. No one would object to the clause which declares that no state shall deprive any person of life, liberty, or property without due process of law, nor to the provision which declares that no state shall deny to any person within its jurisdiction the equal protection of the laws. If the first section of the amendment is thus applied as a restriction against the impairment of fundamental rights, it will not transfer to the federal government the protection of all private rights, as is sometimes supposed, any more than the inhibition against impairing the obligation of contracts transfers to the federal government the cognizauce of all contracts. It does not limit the subjects upon which the states can legislate. Upon every matter, in relation to which previously to its adoption they could have acted, they may still act. They can now, as then, legislate to promote health, good order, and peace, to develop their resources, enlarge their industries, and advance their properity. It only inhibits discriminating and partial enactments,-favoring some to the impairment of the rights of others. The principal, if not the sole, purpose of its prohibitions is to prevent any arbitrary invasion by state authority of the rights of person and property, and to secure to every one the right to pursue his happiness unrestrained, except by just, equal, and impartial laws.

The first section of the amendment is stripped of all its protective force, if its application be limited to the privileges and immunities of citizens of the United States as distinguished from citizens of the states, and thus its prohibition be extended only to the abridgment or impairment of such rights, as the right to come to the seat of government, to secure any claim [111 U.S. 746, 760] they may have upon that government, to transact any business with it, to seek its protection, to share its offices, to engage in administering its functions, to have free access to its seaports, to demand its care and protection over life, liberty, and property on the high seas, or within the jurisdiction of a foreign government, the right to peaceably assemble and petition for redress of grievances, and the right to use the navigable waters of the United States,-which are specified in the opinion in the Slaughter-house Cases as the special rights of such citizens. If thus limited, nothing was accomplished by adopting it. The states could not previously have interfered with these privileges and immunities, or any other privileges and immunities which citizens enjoyed under the coustitution and laws of the United States. Any attempted impairment of them could have been as successfully resisted then as now. The constitution and laws of the United States were as much then as now the supreme law of the land, which all officers of the state

governments were then, as now, bound to obey.

While, therefore, I fully concur in the decision of the court that it was entirely competent for the state to annul the monopoly features of the original act incorporating the plaintiff, I am of opinion that the act, in creating the monopoly in an ordinary employment and business, was to that extent against common right, and void.

BRADLEY, J.

I concur in the judgment of the court in this case, reversing the judgment of the circuit court. I think that the act of the legislature of Louisiana incorporating the Crescent City Live-stock Landing & Slaughter-house Company, and granting to said company for 25 years the exclusive right to erect and maintain stock-landings and slaughter-houses within the limits of the parishes of Orleans, Jefferson, and St. Bernard was not a valid contract, binding upon the state of Louisiana, and protected by the constitution of the United States from alteration or repeal; but my reasons for this opinion are different from those stated in the opinion of the court. They are [111 U.S. 746, 761] not based on the ground that the act was a police regulation. The monopoly clause in the act was clearly not such. It had nothing of the character of a police regulation. That part of the act which regulated the position on the river, relatively to the city of New Orleans, in which slaughter- houses and stock landings should be built, was a police regulation, proper and necessary to prevent the offal of such establishments from floating on the water in front of the city. But such a regulation could be complied with by any butcher erecting a slaughter-house, or by any wharfinger erecting a stock landing; and so could every other real police regulation contained in the act. The police regulations proper were hitched on to the charter as a pretext. The exclusive right given to the company had nothing of police regulation about it whatever. It was the creation of a mere monopoly, and nothing else; a monopoly without consideration and against common right; a monopoly of an ordinary employment and business, which no legislature has power to farm out by contract. Suppose a law should be passed forbidding the erection of any bakery or brewery or soap manufactory within the fire-district, or any other prescribed limits in a large city. That would clearly be a police regulation; but would it be a police regulation to attach to such a law the grant to a single corporation or person of the exclusive right to erect bakeries, breweries, or soap manufactories at any place within 10 miles of the city? Every one would cry out against it as a pretense and an outrage.

I hold it to be an incontrovertible proposition of both English and American public law, that all mere monopolies are odious, and against common right. The practice of granting them in the time of Elizabeth came near creating a revolution. But parliament, then the vindicator of the public liberties, intervened, and passed the act against monopolies. 21 Jas. I. c. 3. The courts had previously, in the last year of Elizabeth, in the great Case of Monopolies, 11 Rep. 84b, decided against the legality of royal grants of this kind. That was only the case of the sole privilege of making cards within the realm; but it was decided on the general principle that all monopoly patents were void, both at common law and by statute, unless granted to the [111 U.S. 746, 762] introducerof a new trade or engine, and then for a reasonable time only; that all trades, as well mechanical as others, which prevent idleness, and enable men to maintain themselves and their families, are profitable to the commonwealth, and therefore the grant of the sole exercise thereof is against not only the common law, 'but the benefit and liberty of the subject.' It was in view of this decision, and in accordance with the principles established by it, that the act of 21 Jas. I. was passed abolishing all monopolies, with the exception f 'letters patent and grants of privileges, for the term of fourteen years or under, of the sole working or vending of any manner of new manufactures to the true and first inventor and inventors of such manufactures, which others, at the time of making such letters patent and grants, shall not us.' As a mere declaration of the common and statute law of England, the Case of Monopolies, and the act of 21 Jas. I., would have but little influence on the question before us, which concerns the power of the legislature of a state to create a monopoly. But

those public transactions have a much greater weight than as mere declarations and enactments of municipal law. They form one of the constitutional landmarks of British liberty, like the petition of right, the habeas corpus act, and other great constitutional acts of parliament. They established and declared one of the inalienable rights of freemen which our ancestors brought with them to this country. The right to follow any of the common occupations of life is an inalienable right, it was formulated as such under the phrase 'pursuit of happiness' in the declaration of independence, which commenced with the fundamental proposition that 'all men are created equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, liberty, and the pursuit of happiness.' This right is a large ingredient in the civil liberty of the citizen. To deny it to all but a few favored individuals, by investing the latter with a monopoly, is to invade one of the fundamental privileges of the citizen, contrary not only to common right, but, as I think, to the express words of the constitution. It is what no legislature has a right to do; and no contract to that end can be binding on subsequent legislatures. [111 U.S. 746, 763] I do not mean to say that there are no exclusive rights which can be granted, or that there are not many regulative restraints on civil action which may be imposed by law. There are such. The granting of patents for inventions, and copyrights for books, is one instance already referred to. This is done upon a fair consideration, and upon grounds of public policy. Society gives to the inventor or author the exclusive benefit for a time of that which, but for him, would not, or might not, have existed; and thus not only repays him, but encourages others to apply their powers for the public utility. So, an exclusive right to use franchises, which could not be exercised without legislative grant, may be given; such as that of constructing and operating public works, railroads, ferries, etc. In such cases a part of the public duty is farmed out to those willing to undertake the burden for the profit incidentally arising from it. So, licenses may be properly required in the pursuit of many professions and avocations which require peculiar skill or supervision for the public welfare. But in such cases there is no real monopoly. The profession or avocation is open to all alike who will prepare themselves with the requisite qualifications, or give the requisite security for preserving public order; except in certain cases, such as the sale of intoxicating drinks, where the interests of society require regulation as to the mumber of establishments, as well as the character of those who carry them on. All such regulations as are here enumerated are entirely competent to the legislature to make. But this concession does not in the slightest degree affect the proposition, (which I deem a fundamental one,) that the ordinary pursuits of life, forming the large mass of industrial avocations, are and ought to be free and open to all, subject only to such general regulations, applying equally to all, as the general good may demand; and the grant to a favored few of a monopoly in any of these common callings is necessarily an outrage upon the liberty of the citizen as exhibited in one of its most important aspects,-the liberty of pursuit. But why is such a grant beyond the legislative power, and contrary to the constitution? The four eenth amendment of the constitution, after [111 U.S. 746, 764] declaring that all persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the state wherein they reside, goes on the declare that 'no state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the law.' I hold that a legislative grant, such as that given to the appellees in this case, is an infringement of each of these prohibitions. It abridges the privileges of citizens of the United States; it deprives them of a portion of their liberty and property without due process of law; and it denies to them the equal protection of the laws.

1. I hold that the liberty of pursuit-the right to follow any of the ordinary callings of life-is one of the privileges of a citizen of the United States. It was held by a majority of the court in the former decision of the Slaughter-house Cases, 16 Wall. 57, that the 'privileges and immunities of citizens of the United States,' mentioned and referred to in the fourteenth amendment, are only those privileges and immunities which were created by the constitution of the United States, and grew out of it, or out of laws passed in pursuance of it. I then held, and still hold, that the phrase has a broader meaning; that it includes those fundamental privileges and immunities which belong essentially to the citizens of every

free government, among which Mr. Justice WASHINGTON enumerates the right of protection; the right to pursue and obtain happiness and safety; the right to pass through and reside in any state for purposes of trade, agriculture, professional pursuits, or otherwise; to claim the benefit of the writ of habeas corpus; to institute and maintain actions of any kind in the courts of the state; and to take, hold, and dispose of property, either real or personal. Corfield v. Corryell, 4 Wash. C. C. 381. These rights are different from the concrete rights which a man may have to a specific chattel or a piece of land, or to the performance by another of a particular contract, or to [111 U.S. 746, 765] damages for a particular wrong, all which may be invaded by individuals; they are the capacity, power, or privilege of having and enjoying those concrete rights, and of maintaining them in the courts, which capacity, power, or privilege can only be invaded by the state. These primordial and fundamental rights are 'the privileges and immunities of citizens' which are referred to in the fourth article of the constitution and in the fourteenth amendment to it. In the former, it is declared that 'the citizens of each state shall be entitled to ALL PRIVILEGES AND IMMUNITIES OF CITIZENS in the several states; that is, in the other states. It was this declaration which Justice WASHINGTON was expounding when he defined what was meant by 'privileges and immunities of citizens.' The fourteenth amendment goes further, and declares that 'no state shall abridge the privileges and immunities of citizens of the United States;' which includes the citizens of the state itself, as well as the citizens of other states. In my opinion, therefore, the law which created the monopoly in question did abridge the privileges of all other citizens, when it gave to the appellees the sole power to have and maintain stock landings and slaughter-houses within the territory named, because these are among those ordinary pursuits and callings which every citizen has a right to follow if he will, subject, of course, to regulations equally open to all.

2. But if it does not abridge the privileges and immunities of a citizen of the United States of prohibit him from pursuing his chosen calling, and giving to others the exclusive right of pursuing it, it certainly does deprive him (to a certain extent) of his liberty, for it takes from him the fre dom of adopting and following the pursuit which he prefers, which, as already intimated, is a material part of the liberty of the citizen. And if a man's right to his calling is property, as many maintain, then those who had already adopted the prohibited pursuits in New Orleans were deprived by the law in question of their property as well as their liberty without due process of law.

3. But still more apparent is the violation, by this monopoly law, of the last clause of the section,-'no state shall deny to any person the equal protection of the laws.' If it is not a [111 U.S. 746, 766] denial of the equal protection of the laws to grant to one man or set of men the privilege of following an ordinary calling in a large community and to deny it to all others, it is difficult to understand what would come within the constitutional prohibition. Monopolies are the bane of our body politic at the present day. In the eager pursuit of gain they are sought in every direction. They exhibit themselves in corners in the stock market and produce market, and in many other ways. If by legislative enactment they can be carried into the common avocations and callings of life, so as to cut off the right of the citizen to choose his avocation,- the right to earn his bread by the trade which he has learned,-and if there is no constitutional means of putting a check to such enormity, I can only say that it is time the constitution was still further amended. In my judgment, the present constitution is amply sufficient for the protection of the people if it is fairly interpreted and faithfully enforced.

HARLAN and WOODS, JJ., concur.

Footnotes

[Footnote 1] S. C. 9 Fed. Rep. 743.

U.S. Supreme Court

COPPAGE v. STATE OF KANSAS, 236 U.S. 1 (1915)

236 U.S. 1

T. B. COPPAGE, Piff. in Err.,
v.
STATE OF KANSAS.
No. 48.

Submitted October 30, 1914.
Decided January 25, 1915.

[236 U.S. 1, 4] Messrs. R. R. Vermilion and W. F. Evans for plaintiff in error.

Mr. John S. Dawson, Attorney General of Kansas, and Mr. J. I. Sheppard for defendant in error.

Mr. Justice Pitney delivered the opinion of the court:

In a local court in one of the counties of Kansas, plaintiff in error was found guilty and adjudged to pay a fine, with imprisonment as the alternative, upon an information charging him with a violation of an act of the legislature of that state, approved March 13, 1903, being chap. 222 of the Session Laws of that year, found also as 4674 and 4675, Gen. Stat. (Kan.) 1909. The act reads as follows:

An Act to Provide a Penalty for Coercing or Influencing or Making Demands upon or Requirements of Employees, Servants, Laborers, and Persons Seeking Employment.

Be it enacted, etc.:

Section 1. That it shall be unlawful for any individual or member of any firm, or any agent, officer, or employee of any company or corporation, to coerce, require, demand, or influence any person or persons to enter into any agreement, either written or verbal, not to join or become or remain a member of any labor organization or association, as a condition of such person or persons securing employment, or continuing in the employment of such individual, firm, or corporation.

Section 2. Any individual or member of any firm, or any

[236 U.S. 1, 7] agent, officer, or employee of any company or corporation violating the provisions of this act, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be fined in a sum not less than $50, or imprisoned in the county jail not less than thirty days.

The judgment was affirmed by the supreme court of the state, two justices dissenting (87 Kan. 752, 125 Pac. 8), and the case is brought here upon the ground that the statute, as construed and applied in this case, is in conflict with that provision of the 14th Amendment of the Constitution of the United States which declares that no state shall deprive any person of liberty or property without due process of law.

The facts, as recited in the opinion of the supreme court, are as follows: About July 1, 1911, one Hedges was employed as a switchman by the St. Louis & San Francisco Railway Company, and was a member of a labor organization called the Switchmen's Union of North America. Plaintiff in error was employed by the railway company as superintendent, and as such he requested Hedges to sign an agreement, which he presented to him in writing, at the same time informing him that if he did not sign it he could not remain in the employ of the company. The following is a copy of the paper thus presented:

Fort Scott, Kansas, _____, 1911

Mr. T. B. Coppage, Superintendent Frisco Lines, Fort Scott:

We, the undersigned, have agreed to abide by your request, that is, to withdraw from the Switchmen's Union, while in the service of the Frisco Company.

(Signed) _____

Hedges refused to sign this, and refused to withdraw from the labor organization. Thereupon plaintiff in error, as such superintendent, discharged him from the service of the company. [236 U.S. 1, 8] At the outset, a few words should be said respecting the construction of the act. It uses the term 'coerce,' and some stress is laid upon this in the opinion of the Kansas supreme court. But, on this record, we have nothing to do with any question of actual or implied coercion or duress, such as might overcome the will of the employee by means unlawful without the act. In the case before us, the state court treated the term 'coerce' as applying to the mere insistence by the employer, or its agent, upon its right to prescribe terms upon which alone it would consent to a continuance of the relationship of employer and employee. In this sense we must understand the statute to have been construed by the court, for in this sense it was enforced in the present case; there being no finding, nor any evidence to support a finding, that plaintiff in error was guilty in any other sense. The entire evidence is included in the bill of exceptions returned with the writ of error, and we have examined it to the extent necessary in order to determine the Federal right that is asserted (Southern P. Co. v. Schuyler, 227 U.S. 601, 611 , 57 S. L. ed. 662, 669, 43 L. R.A.(N.S.) 901, 33 Sup. Ct. Rep. 277, and cases cited). There is neither finding nor evidence that the contract of employment was other than a general or indefinite hiring, such as is presumed to be terminable at the will of either party. The evidence shows that it would have been to the

advantage of Hedges, from a pecuniary point of view and otherwise, to have been permitted to retain his membership in the union, and at the same time to remain in the employ of the railway company. In particular, it shows (although no reference is made to this in the opinion of the court) that, as a member of the union, he was entitled to benefits in the nature of insurance to the amount of $1,500, which he would have been obliged to forego if he had ceased to be a member. But, aside from this matter of pecuniary interest, there is nothing to show that Hedges was subjected to the least pressure or influence, or that he was not [236 U.S. 1, 9] a free agent, in all respects competent, and at liberty to choose what was best from the standpoint of his own interests. Of course, if plaintiff in error, acting as the representative of the railway company, was otherwise within his legal rights in insisting that Hedges should elect whether to remain in the employ of the company or to retain his membership in the union, that insistence is not rendered unlawful by the fact that the choice involved a pecuniary sacrifice to Hedges. Silliman v. United States, 101 U.S. 465, 470 , 471 S., 25 L. ed. 987-989; Hackley v. Headley, 45 Mich. 569, 576, 8 N. W. 511; Emery v. Lowell, 127 Mass. 138, 141; Custin v. Viroqua, 67 Wis. 314, 320, 30 N. W. 515. And if the right that plaintiff in error exercised is founded upon a constitutional basis, it cannot be impaired by merely applying to its exercise the term 'coercion.' We have to deal, therefore, with a statute that, as construed and applied, makes it a criminal offense, punishable with fine or imprisonment, for an employer or his agent to merely prescribe, as a condition upon which one may secure certain employment or remain in such employment (the employment being terminable at will), that the employee shall enter into an agreement not to become or remain a member of any labor organization while so employed; the employee being subject to no incapacity or disability, but, on the contrary, free to exercise a voluntary choice.

In Adair v. United States, 208 U.S. 161 , 52 L. ed. 436, 28 Sup. Ct. Rep. 277, 13 Ann. Cas. 764, this court had to deal with a question not distinguishable in principle from the one now presented. Congress, in 10 of an act of June 1, 1898, entitled, 'An Act Concerning Carriers Engaged in Interstate Commerce and Their Employees' (30 Stat. at L. 424, 428, chap. 370), had enacted 'that any employer subject to the provisions of this act, and any officer, agent, or receiver of such employer, who shall require any employee, or any person seeking employment, as a condition of such employment, to enter into an agreement, either written or verbal, not to become or remain a member [236 U.S. 1, 10] of any labor corporation, association, or organization; or shall threaten any employee with loss of employment, or shall unjustly discriminate against any employee because of his membership in such a labor corporation, association, or organization . . . is hereby declared to be guilty of a misdemeanor, and, upon conviction thereof . . . shall be punished for each offense by a fine of not less than one hundred dollars and not more than one thousand dollars.' Adair was convicted upon an indictment charging that he, as agent of a common carrier subject to the provisions of the act, unjustly discriminated against a certain employee by discharging him from the employ of the carrier because of his membership in a labor organization. The court held that portion of the act upon which the conviction rested to be an invasion of the personal liberty as well as of the right of property guaranteed by the 5th Amendment, which declares that no person shall be deprived of liberty or property without due process of law. Speaking by Mr. Justice Harlan, the court said (p. 174): 'While, as already suggested, the right of liberty and property guaranteed by the Constitution against deprivation without due process of law is subject to such reasonable restraints as the common good or the general welfare may require, it is not within the functions of government-at least, in the absence of contract between the parties-to compel any person in the course of his business and against his will to accept or retain the personal services of another, or to compel any person, against his will, to perform personal services for another. The right of a person to sell his labor upon such terms as he deems proper is, in its essence, the same as the right of the purchaser of labor to prescribe the conditions upon which he will accept such labor from the person offering to sell it. So the right of the employee to quit the service of the employer, for whatever reason, is the same as the right of the employer, for whatever reason, to dispense with the services of such [236 U.S. 1, 11] employee. It was the legal right of the defendant Adair-however unwise such a course might have been-to discharge Coppage [the employee in that case] because of his being a member of a labor

organization, as it was the legal right of Coppage, if he saw fit to do so,-however unwise such a course on his part might have been,-to quit the service in which he was engaged, because the defendant employed some persons who were not members of a labor organization. In all such particulars the employer and the employee have equality of right, and any legislation that disturbs that equality is an arbitrary interference with the liberty of contract, which no government can legally justify in a free land.'

Unless it is to be overruled, this decision is controlling upon the present controversy; for if Congress is prevented from arbitrary interference with the liberty of contract because of the 'due process' provision of the 5th Amendment, it is too clear for argument that the states are prevented from the like interference by virtue of the corresponding clause of the 14th Amendment; and hence, if it be unconstitutional for Congress to deprive an employer of liberty or property for threatening an employee with loss of employment, or discriminating against him because of his membership in a labor organization, it is unconstitutional for a state to similarly punish an employer for requiring his employee, as a condition of securing or retaining employment, to agree not to become or remain a member of such an organization while so employed.

It is true that, while the statute that was dealt with in the Adair Case contained a clause substantially identical with the Kansas act now under consideration,-a clause making it a misdemeanor for an employer to require an employee or applicant for employment, as a condition of such employment, to agree not to become or remain a member of a labor organization,-the conviction was [236 U.S. 1, 12] based upon another clause, which related to discharging an employee because of his membership in such an organization; and the decision, naturally, was confined to the case actually presented for decision. In the present case, the Kansas supreme court sought to distinguish the Adair decision upon this ground. The distinction, if any there be, has not previously been recognized as substantial, so far as we have been able to find. The opinion in the Adair Case, while carefully restricting the decision to the precise matter involved, cited (208 U. S. on page 175), as the first in order of a number of decisions supporting the conclusion of the court, a case (People v. Marcus, 185 N. Y. 257, 7 L.R.A.(N.S.) 282, 113 Am. St. Rep. 902, 77 N. E. 1073, 7 Ann. Cas. 188) in which the statute denounced as unconstitutional was in substance the counterpart of the one with which we are now dealing.

But, irrespective of whether it has received judicial recognition, is there any real distinction? The constitutional right of the employer to discharge an employee because of his membership in a labor union being granted, can the employer be compelled to resort to this extreme measure? May he not offer to the employee an option, such as was offered in the instant case, to remain in the employment if he will retire from the union; to sever the former relationship only if he prefers the latter? Granted the equal freedom of both parties to the contract of employment, has not each party the right to stipulate upon what terms only he will consent to the inception, or to the continuance, of that relationship? And may he not insist upon an express agreement, instead of leaving the terms of the employment to be implied? Can the legislature in effect require either party at the beginning to act covertly; concealing essential terms of the employment-terms to which, perhaps, the other would not willingly consent- and revealing them only when it is proposed to insist upon them as a ground for terminating the relationship? Supposing an employer is unwilling to have in his [236 U.S. 1, 13] employ one holding membership in a labor union, and has reason to suppose that the man may prefer membership in the union to the given employment without it-we ask, can the legislature oblige the employer in such case to refrain from dealing frankly at the outset? And is not the employer entitled to insist upon equal frankness in return? Approaching the matter from a somewhat different standpoint, is the employee's right to be free to join a labor union any more sacred, or more securely founded upon the Constitution, than his right to work for whom he will, or to be idle if he will? And does not the ordinary contract of employment include an insistence by the employer that the employee shall agree, as a condition of the employment, that he will not be idle and will not work for whom he pleases, but will serve his present

employer, and him only, so long as the relation between them shall continue? Can the right of making contracts be enjoyed at all, except by parties coming together in an agreement that requires each party to forego, during the time and for the purpose covered by the agreement, any inconsistent exercise of his constitutional rights?

These queries answer themselves. The answers, as we think, lead to a single conclusion: Under constitutional freedom of contract, whatever either party has the right to treat as sufficient ground for terminating the employment, where there is no stipulation on the subject, he has the right to provide against by insisting that a stipulation respecting it shall be a sine qua non of the inception of the employment, or of its continuance if it be terminable at will. It follows that this case cannot be distinguished from Adair v. United States.

The decision in that case was reached as the result of elaborate argument and full consideration. The opinion states (208 U.S. 171): 'This question is admittedly one of importance, and has been examined with care and deliberation. And the court has reached a conclusion [236 U.S. 1, 14] which, in its judgment, is consistent with both the words and spirit of the Constitution, and is sustained as well by sound reason.' We are now asked, in effect, to overrule it; and in view of the importance of the issue we have reexamined the question from the standpoint of both reason and authority. As a result, we are constrained to reaffirm the doctrine there applied. Neither the doctrine nor this application of it is novel; we will endeavor to restate some of the grounds upon which it rests. The principle is fundamental and vital. Included in the right of personal liberty and the right of private property-partaking of the nature of each- is the right to make contracts for the acquisition of property. Chief among such contracts is that of personal employment, by which labor and other services are exchanged for money or other forms of property. If this right be struck down or arbitrarily interfered with, there is a substantial impairment of liberty in the long-established constitutional sense. The right is as essential to the laborer as to the capitalist, to the poor as to the rich; for the vast majority of persons have no other honest way to begin to acquire property, save by working for money.

An interference with this liberty so serious as that now under consideration, and so disturbing of equality of right, must be deemed to be arbitrary, unless it be supportable as a reasonable exercise of the police power of the state. But, notwithstanding the strong general presumption in favor of the validity of state laws, we do not think the statute in question, as construed and applied in this case, can be sustained as a legitimate exercise of that power. To avoid possible misunderstanding, we should here emphasize, what has been said before, that so far as its title or enacting clause expresses a purpose to deal with coercion, compulsion, duress, or other undue influence, we have no present concern with it, because nothing of that sort is involved in this case. As has [236 U.S. 1, 15] been many times stated, this court deals not with moot cases or abstract questions, but with the concrete case before it. California v. San Pablo & T. R. Co. 149 U.S. 308, 314 , 37 S. L. ed. 747, 748, 13 Sup. Ct. Rep. 876; Richardson v. McChesney, 218 U.S. 487, 492 , 54 S. L. ed. 1121, 1122, 31 Sup. Ct. Rep. 43; Missouri, K. & T. R. Co. v. Cade, 233 U.S. 642, 648 , 58 S. L. ed. 1135, 1137, 34 Sup. Ct. Rep. 678. We do not mean to say, therefore, that a state may not properly exert its police power to prevent coercion on the part of employers towards employees, or vice versa. But, in this case, the Kansas court of last resort has held that Coppage, the plaintiff in error, is a criminal, punishable with fine or imprisonment under this statute, simply and merely because, while acting as the representative of the railroad company, and dealing with Hedges, an employee at will and a man of full age and understanding, subject to no restraint or disability, Coppage insisted that Hedges should freely choose whether he would leave the employ of the company or would agree to refrain from association with the union while so employed. This construction is, for all purposes of our jurisdiction, conclusive evidence that the state of Kansas intends by this legislation to punish conduct such as that of Coppage, although entirely devoid of any element of coercion, compulsion, duress, or undue influence, just as certainly as it intends to punish coercion and the like. But, when a party appeals to this court for the protection of rights secured to him

by the Federal Constitution, the decision is not to depend upon the form of the state law, nor even upon its declared purpose, but rather upon its operation and effect as applied and enforced by the state; and upon these matters this court cannot, in the proper performance of its duty, yield its judgment to that of the state court. St. Louis South Western R. Co. v. Arkansas, 235 U.S. 350, 362 , 59 S. L. ed. --, 35 Sup. Ct. Rep. 99, and cases cited. Now, it seems to us clear that a statutory provision which is not a legitimate police regulation cannot be made such by being placed in the same act with a police regulation, or by being enacted under a title that declares a [236 U.S. 1, 16] purpose which would be a proper object for the exercise of that power. 'Its true character cannot be changed by its collocation,' as Mr. Justice Grier said in the Passenger Cases, 7 How. 458, 12 L. ed. 775. It is equally clear, we think, that to punish an employer or his agent for simply proposing certain terms of employment, under circumstances devoid of coercion, duress, or undue influence, has no reasonable relation to a declared purpose of repressing coercion, duress, and undue influence. Nor can a state, by designating as 'coercion' conduct which is not such in truth, render criminal any normal and essentially innocent exercise of personal liberty or of property rights; for to permit this would deprive the 14th Amendment of its effective force in this regard. We, of course, do not intend to attribute to the legislature or the courts of Kansas any improper purposes or any want of candor; but only to emphasize the distinction between the form of the statute and its effect as applied to the present case.

Laying aside, therefore, as immaterial for present purposes, so much of the statute as indicates a purpose to repress coercive practices, what possible relation has the residue of the act to the public health, safety, morals, or general welfare? None is suggested, and we are unable to conceive of any. The act, as the construction given to it by the state court shows, is intended to deprive employers of a part of their liberty of contract, to the corresponding advantage of the employed and the upbuilding of the labor organizations. But no attempt is made, or could reasonably be made, to sustain the purpose to strengthen these voluntary organizations, any more than other voluntary associations of persons, as a legitimate object for the exercise of the police power. They are not public institutions, charged by law with public or governmental duties, such as would render the maintenance of their membership a matter of direct concern to the general [236 U.S. 1, 17] welfare. If they were, a different question would be presented.

As to the interest of the employed, it is said by the Kansas supreme court to be a matter of common knowledge that 'employees, as a rule, are not financially able to be as independent in making contracts for the sale of their labor as are employers in making a contract of purchase thereof.' No doubt, wherever the right of private property exists, there must and will be inequalities of fortune; and thus it naturally happens that parties negotiating about a contract are not equally unhampered by circumstances. This applies to all contracts, and not merely to that between employer and employee. Indeed, a little reflection will show that wherever the right of private property and the right of free contract coexist, each party when contracting is inevitably more or less influenced by the question whether he has much property, or little, or none; for the contract is made to the very end that each may gain something that he needs or desires more urgently than that which he proposes to give in exchange. And, since it is self-evident that, unless all things are held in common, some persons must have more property than others, it is from the nature of things impossible to uphold freedom of contract and the right of private property without at the same time recognizing as legitimate those inequalities of fortune that are the necessary result of the exercise of those rights. But the 14th Amendment, in declaring that a state shall not 'deprive any person of life, liberty, or property without due process of law,' gives to each of these an equal sanction; it recognizes 'liberty' and 'property' as coexistent human rights, and debars the states from any unwarranted interference with either.

And since a state may not strike them down directly, it is clear that it may not do so indirectly, as by declaring in effect that the public good requires the removal of those [236 U.S. 1, 18] inequalities that are but the normal and inevitable result of their exercise, and then invoking the police power in order to

remove the inequalities, without other object in view. The police power is broad, and not easily defined, but it cannot be given the wide scope that is here asserted for it, without in effect nullifying the constitutional guaranty.

We need not refer to the numerous and familiar cases in which this court has held that the power may properly be exercised for preserving the public health, safety, morals, or general welfare, and that such police regulations may reasonably limit the enjoyment of personal liberty, including the right of making contracts. They are reviewed in Holden v. Hardy, 169 U.S. 366, 391 , 42 S. L. ed. 780, 790, 18 Sup. Ct. Rep. 383; Chicago, B. & Q. R. Co. v. McGuire, 219 U.S. 549, 566 , 55 S. L. ed. 328, 338, 31 Sup. Ct. Rep. 259; Erie R. Co. v. Williams, 233 U.S. 685 , 58 L. ed. 1155, 34 Sup. Ct. Rep. 761; and other recent decisions. An evident and controlling distinction is this: that in those cases it has been held permissible for the states to adopt regulations fairly deemed necessary to secure some object directly affecting the public welfare, even though the enjoyment of private rights of liberty and property be thereby incidentally hampered; while in that portion of the Kansas statute which is now under consideration-that is to say, aside from coercion, etc.-there is no object or purpose, expressed or implied, that is claimed to have reference to health, safety, morals, or public welfare, beyond the supposed desirability of leveling inequalities of fortune by depriving one who has property of some part of what is characterized as his 'financial independence.' In short, an interference with the normal exercise of personal liberty and property rights is the primary object of the statute, and not an incident to the advancement of the general welfare. But, in our opinion, the 14th Amendment debars the states from striking down personal liberty or property rights, or materially restricting their normal exercise, excepting [236 U.S. 1, 19] so far as may be incidentally necessary for the accomplishment of some other and paramount object, and one that concerns the public welfare. The mere restriction of liberty or of property rights cannot of itself be denominated 'public welfare,' and treated as a legitimate object of the police power; for such restriction is the very thing that is inhibited by the Amendment.

It is said in the opinion of the state court that membership in a labor organization does not necessarily affect a man's duty to his employer; that the employer has no right, by virtue of the relation, 'to dominate the life nor to interfere with the liberty of the employee in matters that do not lessen or deteriorate the service;' and that 'the statute implies that labor unions are lawful and not inimical to the rights of employers.' The same view is presented in the brief of counsel for the state, where it is said that membership in a labor organization is the 'personal and private affair' of the employee. To this line of argument it is sufficient to say that it cannot be judicially declared that membership in such an organization has no relation to a member's duty to his employer; and therefore, if freedom of contract is to be preserved, the employer must be left at liberty to decido for himself whether such membership by his employee is consistent with the satisfactory performance of the duties of the employment.

Of course we do not intend to say, nor to intimate, anything inconsistent with the right of individuals to join labor unions, nor do we question the legitimacy of such organizations so long as they conform to the laws of the land as others are required to do. Conceding the full right of the individual to join the union, he has no inherent right to do this and still remain in the employ of one who is unwilling to employ a union man, any more than the same individual has a right to join the union without the consent of that organization. Can it be doubted that a [236 U.S. 1, 20] labor organization-a voluntary association of working men-has the inherent and constitutional right to deny membership to any man who will not agree that during such membership he will not accept or retain employment in company with nonunion men? Or that a union man has the constitutional right to decline proffered employment unless the employer will agree not to employ any nonunion man? (In all cases we refer, of course, to agreements made voluntarily, and without coencion or duress as between the parties. And we have no reference to questions of monopoly, or interference with the rights of third parties or the general public. There involve other considerations, respecting which we intend to intimate no opinion. See Curran v. Galen, 152 N. Y. 33, 37 L.R.A. 802, 57 Am. St. Rep. 496, 46 N. E. 297; Jacobs v. Cohen, 183 N. Y.

207, 213, 214, 2 L.R.A.(N.S.) 292, 111 Am. St. Rep. 730, 76 N. E. 5, 5 Ann. Cas. 280; Plant v. Woods, 176 Mass. 492, 51 L.R.A. 339, 79 Am. St. Rep. 330, 57 N. E. 1011; Berry v. Donovan, 188 Mass. 353, 5 L.R.A.(N.S.) 899, 108 Am. St. Rep. 499, 74 N. E. 603, 3 Ann. Cas. 738; Brennan v. United Hatters, 73 N. J. L. 729, 738, 9 L. R.A.(N.S.) 254, 118 Am. St. Rep. 727, 65 Atl. 165, 169, 9 Ann. Cas. 698, 702). And can there be one rule of liberty for the labor organization and its members, and a different and more restrictive rule for employers? We think not; and since the relation of employer and employee is a voluntary relation, as clearly as is that between the members of a labor organization, the employer has the same inherent right to prescribe the terms upon which he will consent to the relationship, and to have them fairly understood and expressed in advance.

When a man is called upon to agree not to become or remain a member of the union while working for a particular employer, he is in effect only asked to deal openly and frankly with his employer, so as not to retain the employment upon terms to which the latter is not willing to agree. And the liberty of making contracts does not include a liberty to procure employment from an unwilling employer, or without a fair understanding. Nor may the [236 U.S. 1, 21] employer be foreclosed by legislation from exercising the same freedom of choice that is the right of the employee.

To ask a man to agree, in advance, to refrain from affiliation with the union while retaining a certain position of employment, is not to ask him to give up any part of his constitutional freedom. He is free to decline the employment on those terms, just as the employer may decline to offer employment on any other; for 'it takes two to make a bargain.' Having accepted employment on those terms, the man is still free to join the union when the period of employment expires; or, if employed at will, then at any time upon simply quitting the employment. And, if bound by his own agreement to refrain from joining during a stated period of employment, he is in no different situation from that which is necessarily incident to term contracts in general. For constitutional freedom of contract does not mean that a party is to be as free after making a contract as before; he is not free to break it without accountability. Freedom of contract, from the very nature of the thing, can be enjoyed only by being exercised; and each particular exercise of it involves making an engagement which, if fulfilled, prevents for the time any inconsistent course of conduct.

So much for the reason of the matter, let us turn again to the adjudicated cases.

The decision in the Adair Case is in accord with the almost unbroken current of authorities in the state courts. In many states enactments not distinguishable in principle from the one now in question have been passed, but, except in two instances (one, the decision of an inferior court in Ohio, since repudiated; the other, the decision now under review), we are unable to find that they have been judicially enforced. It is not too much to say that such laws have by common consent been treated as unconstitutional, for while many state courts of last resort have adjudged them void, we have found no decision by such a court [236 U.S. 1, 22] sustaining legislation of this character, excepting that which is now under review. The single previous instance in which any court has upheld such a statute is Davis v. State (1893) 30 Ohio L. J. 342, 11 Ohio Dec. Reprint, 894, where the court of common pleas of Hamilton county sustained an act of April 14, 1892 (89 Ohio Laws, 269), which declared that any person who coerced or attempted to coerce employees by discharging or threatening to discharge them because of their connection with any lawful labor organization should be guilty of a misdemeanor, and upon conviction fined or imprisoned. We are unable to find that this decision was ever directly reviewed; but in State v. Bateman (1900) 10 Ohio S. & C. P. Dec. 68, 7 Ohio N. P. 487, its authority was repudiated upon the ground that it had been in effect overruled by subsequent decisions of the state supreme court, and the same statute was held unconstitutional.

The right that plaintiff in error is now seeking to maintain was held by the supreme court of Kansas, in

an earlier case, to be within the protection of the 14th Amendment, and therefore beyond legislative interference. In Coffeyville Vitrified Brick & Tile Co. v. Perry, 69 Kan. 297, 66 L.R.A. 185, 76 Pac. 848, 1 Ann. Cas. 936, the court had under consideration chapter 120 of the Laws of 1897 (Gen. Stat. 1901, 2425, 2426), which declared it unlawful for any person, company, or corporation, or agent, officer, etc., to prevent employees from joining and belonging to any labor organization, and enacted that any such person, company, or corporation, etc., that coerced or attempted to coerce employees by discharging or threatening to discharge them because of their connection with such labor organization should be deemed guilty of a misdemeanor, and upon conviction subjected to a fine, and should also be liable to the person injured in punitive damages. It was attacked as violative of the 14th Amendment, and also of the Bill of Rights of the state [236 U.S. 1, 23] Constitution. 1 The court held it unconstitutional, saying: 'The right to follow any lawful vocation and to make contracts is as completely within the protection of the Constitution as the right to hold property free from unwarranted seizure, or the liberty to go when and where one will. One of the ways of obtaining property is by contract. The right, therefore, to contract cannot be infringed by the legislature without violating the letter and spirit of the Constitution. Every citizen is protected in his right to work where and for whom he will. He may select not only his employer, but also his associates. He is at liberty to refuse to continue to serve one who has in his employ a person, or an association of persons, objectionable to him. In this respect the rights of the employer and employee are equal. Any act of the legislature that would undertake to imposs on an employer the obligation of keeping in his service one whom, for any reason, he should not desire, would be a denial of his constitutional right to make and terminate contracts and to acquire and hold property. Equally so would be an act the provisions of which should be intended to require one to remain in the service of one whom he should not desire to serve. . . . The business conducted by the defendant was its property, and in the exercise of this ownership it is protected by the Constitution. It could abandon or discontinue its operation at pleasure. It had the right, beyond the possibility of legislative interference, to make any contract with reference thereto not in violation of law. [236 U.S. 1, 24] In the operation of its property it may employ such persons as are desirable, and discharge, without reason, those who are undesirable. It is at liberty to contract for the services of persons in any manner that is satisfactory to both. No legislative restrictions can be imposed upon the lawful exercise of these rights.'

In Atchison, T. & S. F. R. Co. v. Brown, 80 Kan. 312, 23 L.R.A.(N.S.) 247, 133 Am. St. Rep. 213, 102 Pac. 459, 18 Ann. Cas. 346, the same court passed upon chapter 144 of the Laws of 1897 (Gen. Stat. 1901, 2421-2424), which required the employer, upon the request of a discharged employee, to furnish in writing the true cause or reason for such discharge. The railway company did not meet this requirement, its 'service letter.' as it was called, stating only that Brown was discharged 'for cause,' which the court naturally held was not a statement of the cause. The law was held unconstitutional, upon the ground (80 Kan. 315) that an employer may discharge his employee for any reason, or for no reason, just as an employee may quit the employment for any reason, or for no reason; that such action on the part of employer or employee, where no obligation is violated, is an essential element of liberty in action; and that one cannot be compelled to give a reason or cause for an action for which he may have no specific reason or cause, except, perhaps, a mere whim or prejudice.

In the present case the court did not repudiate or overrule these previous decisions, but, on the contrary, cited them as establishing the right of the employer to discharge his employee at any time, for any reason, or for no reason, being responsible in damages for violating a contract as to the time of employment, and as establishing, conversely, the right of the employee to quit the employment at any time, for any reason, or without any reason, being likewise responsible in damages for a violation of his contract with the employer. The court held the act of 1903 that is now in question to be distinguishable from the [236 U.S. 1, 25] act of 1897, upon grounds sufficiently indicated and answered by what we have already said.

In five other states the courts of last resort have had similar acts under consideration, and in each instance have held them unconstitutional. In State v. Julow (1895) 129 Mo. 163, 29 L.R.A. 257, 50 Am. St. Rep. 443, 31 S. W. 781, the supreme court of Missouri dealt with an act (Missouri Laws 1893, p. 187) that forbade employers, on pain of fine or imprisonment, to enter into any agreement with an employee requiring him to withdraw from a labor union or other lawful organization, or to refrain from joining such an organization, or to 'by any means attempt to compel or coerce any employee into withdrawal from any lawful organization or society.' In Gillespie v. People (1900) 188 Ill. 176, 52 L.R.A. 283, 80 Am. St. Rep. 176, 58 N. E. 1007, the supreme court of Illinois held unconstitutional an act (Hurd's Stat. 1899, p. 844) declaring it criminal for any individual or member of any firm, etc., to prevent or attempt to prevent employees from forming, joining, and belonging to any lawful labor organization, and that any such person 'that coerces or attempts to coerce employees by discharging or threatening to discharge them because of their connection with such lawful labor organization' should be guilty of a misdemeanor. In State ex rel. Zillmer v. Kreutzberg (1902) 114 Wis. 530, 58 L.R.A. 748, 91 Am. St. Rep. 934, 90 N. W. 1098, the court had under consideration a statute (Wisconsin Laws 1899, chap. 332) which, like the Kansas act now in question, prohibited the employer or his agent from coercing the employee to enter into an agreement not to become a member of a labor organization, as a condition of securing employment or continuing in the employment, and also rendered it unlawful to discharge an employee because of his being a member of any labor organization. The decision related to the latter prohibition, but this was denounced [236 U.S. 1, 26] upon able and learned reasoning that has a much wider reach. In People v. Marcus (1906) 185 N. Y. 257, 7 L.R.A.(N.S.) 282, 113 Am. St. Rep. 902, 77 N. E. 1073, 7 Ann. Cas. 118, the statute dealt with (N. Y. Laws 1887, chap. 688), as we have already said, was in substance identical with the Kansas act. These decisions antedated Adair v. United States. They proceed upon broad and fundamental reasoning, the same in substance that was adopted by this court in the Adair Case, and they are cited with approval in the opinion (208 U.S. 175). A like result was reached in State ex rel. Smith v. Daniels (1912) 118 Minn. 155, 136 N. W. 584, with respect to an act that, like the Kansas statute, forbade an employer to require an employee or person seeking employment, as a condition of such employment, to make an agreement that the employee would not become or remain a member or a labor organization. This was held invalid upon the authority of the Adair Case. And see Goldfield Consol. Mines Co. v. Goldfield Miners' Union, 159 Fed. 500, 513.

Upon both principle and authority, therefore, we are constrained to hold that the Kansas act of March 13, 1903, as construed and applied so as to punish with fine or imprisonment an employer or his agent for merely prescribing, as a condition upon which one may secure employment under or remain in the service of such employer, that the employee shall enter into an agreement not to become or remain a member of any labor organization while so employed, is repugnant to the 'due process' clause of the 14th Amendment, and therefore void.

Judgment reversed, and the cause remanded for further proceedings not inconsistent with this opinion.

Mr. Justice Holmes, dissenting:

I think the judgment should be affirmed. In present conditions a workman not unnaturally may believe that [236 U.S. 1, 27] only by belonging to a union can he secure a contract that shall be fair to him. Holden v. Hardy, 169 U.S. 366, 397 , 42 S. L. ed. 780, 792, 18 Sup. Ct. Rep. 383; Chicago, B. & Q. R. Co. v. McGuire, 219 U.S. 549, 570 , 55 S. L. ed. 328, 339, 31 Sup. Ct. Rep. 259. If that belief, whether right or wrong, may be held by a reasonable man, it seems to me that it may be enforced by law in order to establish the equality of position between the parties in which liberty of contract begins. Whether in the long run it is wise for the workingmen to enact legislation of this sort is not my concern, but I am strongly of opinion that there is nothing in the Constitution of the United States to prevent it, and that Adair v. United States, 208 U.S. 161 , 52 L. ed. 436, 28 Sup. Ct. Rep. 277, 13 Ann. Cas. 764, and

Lochner v. New York, 198 U.S. 45 , 49 L. ed. 937, 25 Sup. Ct. Rep. 539, 3 Ann. Cas. 1133, should be overruled. I have stated my grounds in those cases and think it unnecessary to add others that I think exist. See further, Vegelahn v. Guntner, 167 Mass. 92, 104, 108, 35 L.R.A. 722, 57 Am. St. Rep. 443, 44 N. E. 1077; Plant v. Woods, 176 Mass. 492, 505, 51 L.R.A. 339, 79 Am. St. Rep. 330, 57 N. E. 1011. I still entertain the opinions expressed by me in Massachusetts.

Mr. Justice Day, dissenting:

The character of the question here involved sufficiently justifies, in my opinion, a statement of the grounds which impel me to dissent from the opinion and judgment in this case. The importance of the decision is further emphasized by the fact that it results not only in invalidating the legislation of Kansas, now before the court, but necessarily decrees the same fate to like legislation of other states of the Union. 2 This far- reaching result is attained because the statute is declared to be an infraction [236 U.S. 1, 28] of the constitutional protection afforded under the 14th Amendment to the Federal Constitution, which declares that no person shall be deprived of life, liberty, or property without due process of law. The right of contract, it is said, is part of the liberty of the citizen, and to abridge it, as is done in this case, is declared to be beyond the legislative authority of the state.

That the right of contract is a part of individual freedom within the protection of this Amendment, and may not be arbitrarily interfered with, is conceded. While this is true, nothing is better settled by the repeated decisions of this court than that the right of contract is not absolute and unyielding, but is subject to limitation and restraint in the interests of the public health, safety, and welfare, and such limitations may be declared in legislation of the state. It would unduly extend what I purpose to say in this case to refer to all the cases in which this doctrine has been declared. One of them is: Frisbie v. United States, 157 U.S. 160 , 39 L. ed. 657, 15 Sup. Ct. Rep. 586. In that case, it was declared, and in varying form has been repeated many times since:

> 'While it may be conceded that, generally speaking, among the inalienable rights of the citizen is that of the liberty of contract, yet such liberty is not absolute and universal. It is within the undoubted power of government to restrain some individuals from all contracts, as well as all individuals from some contracts. It may deny to all the right to contract for the purchase or sale of lottery tickets; to the minor the right to assume any obligations, except for the necessaries of existence; to the common carrier the power to make any contract releasing himself from negligence, and, indeed, may restrain all engaged in any employment from any contract in the course of that employment which is against public policy. The possession of this power by government in no manner conflicts with the proposition that, generally [236 U.S. 1, 29] speaking, every citizen has a right freely to contract for the price of his labor, services, or property.'

See also Holden v. Hardy, 169 U.S. 366, 391 , 42 S. L. ed. 780, 790, 18 Sup. Ct. Rep. 383; Atkin v. Kansas, 191 U.S. 207 , 48 L. ed. 148, 24 Sup. Ct. Rep. 124; Muller v. Oregon, 208 U.S. 412, 421 , 52 S. L. ed. 551, 555, 28 Sup. Ct. Rep. 324, 13 Ann. Cas. 957; McLean v. Arkansas, 211 U.S. 539 , 53 L. ed. 315, 29 Sup. Ct. Rep. 206; Chicago, B. & Q. R. Co. v. McGuire, 219 U.S. 549 , 55 L. ed. 328, 31 Sup. Ct. Rep. 259; Atlantic Coast Line R. Co. v. Riverside Mills, 219 U.S. 186, 202 , 55 S. L. ed. 167, 180, 31 L.R.A. (N.S .) 7, 31 Sup. Ct. Rep. 164; Erie R. Co. v. Williams, 233 U.S. 685, 699 , 58 S. L. ed. 1155, 1160, 34 Sup. Ct. Rep. 761. The Erie Railroad Case is a very recent deliverance of this court upon the subject, wherein it was declared:

> 'But liberty of making contracts is subject to conditions in the interest of the public welfare, and which shall prevail-principle or condition-cannot be defined by any precise and universal formula. Each instance of asserted conflict must be determined by itself, and it has been said

> many times that each act of legislation has the support of the presumption that it is an exercise in the interest of the public. The burden is on him who attacks the legislation, and it is not sustained by declaring a liberty of contract. It can only be sustained by demonstrating that it conflicts with some constitutional restraint, or that the public welfare is not subserved by the legislation. The legislature is, in the first instance, the judge of what is necessary for the public welfare, and a judicial review of its judgment is limited. The earnest conflict of serious opinion does not suffice to bring it within the range of judicial cognizance. Chicago, B. & Q. R. Co. v. McGuire, 219 U.S. 549, 565 , 55 S. L. ed. 328, 337, 31 Sup. Ct. Rep. 259; German Alliance Ins. Co. v. Lewis, 233 U.S. 389 , 58 L. ed. 1011, 34 Sup. Ct. Rep. 612.'

It is therefore the thoroughly established doctrine of this court that liberty of contract may be circumscribed in the interest of the state and the welfare of its people. Whether a given exercise of such authority transcends the limits of legislative authority must be determined in each case as it arises. The preservation of the police power of the states, under the authority of which that [236 U.S. 1, 30] great mass of legislation has been enacted which has for its purpose the promotion of the health, safety, and welfare of the public, is of the utmost importance. This power was not surrendered by the states when the Federal Constitution was adopted, nor taken from them when the 14th Amendment was ratified and became a part of the fundamental law of the Union. Barbier v. Connolly, 113 U.S. 27 , 28 L. ed. 923, 5 Sup. Ct. Rep. 357.

Of the necessity of such legislation, the local legislature is itself the judge, and its enactments are only to be set aside when they involve such palpable abuse of power and lack of reasonableness to accomplish a lawful end that they may be said to be merely arbitrary and capricious, and hence out of place in a government of laws, and not of men, and irreconcilable with the conception of due process of law. McGehee on Due Process of Law, page 306, and cases from this court therein cited.

By this it is not meant that the legislative power is beyond judicial review. Such enactments as are arbitrary or unreasonable, and thus exceed the exercise of legislative authority in good faith, may be declared invalid when brought in review by proper judicial proceedings. This is necessary to the assertion and maintenance of the supremacy of the Constitution.

Conceding, then, that the right of contract is a subject of judicial protection, within the authority given by the Constitution of the United States, the question here is, was the power of the state so arbitrarily exercised as to render its action unconstitutional and therefore void? It is said that this question is authoritatively determined in this court, in the case of Adair v. United States, 208 U.S. 161 , 52 L. ed. 436, 28 Sup. Ct. Rep. 277, 13 Ann. Cas. 764. In that case, a statute passed by the Congress of the United States, under supposed sanction of the power to regulate interstate commerce, was before this court, and it was there decided that the right of contract protected by the 5th Amendment to the Constitution, [236 U.S. 1, 31] providing that no person shall be deprived of life, liberty, or property without due process of law, avoided a statute which undertook to make it a crime to discharge an employee simply because of his membership in a labor organization. The feature of the statute which is here involved, making it an offense to require any employee, or any person seeking employment, as a condition of such employment, to enter into an agreement, either written or verbal, not to become a member of any labor corporation, association, or organization,-a provision exactly similar to that of the Kansas statute now under consideration,-was not before the court upon the charge made or the facts shown, and this provision was neither considered nor decided upon in reaching the conclusion that an employer could not be made a criminal because he discharged an employee simply because of his membership in a labor organization. In the course of the opinion this fact was more than once stated, and the question before the court declared to be:

> 'May Congress make it a criminal offense against the United States-as by the 10th section of the act of 1898 it does-for an agent or officer of an interstate carrier, having full authority in the premises from the carrier, to discharge an employee from service simply because of his membership in a labor organization?'

Such was the question before the court, and that there might be no mistake about it, at the close of the opinion, the part of the act upon which the defendant in that case was convicted was declared to be separable from the other parts of the act, and that feature of the statute the only subject of decision. Mr. Justice Harlan, concluding the opinion of the court, said:

> 'We add that since the part of the act of 1898 upon which the first count of the indictment is based, and upon which alone the defendant was convicted, is severable from its other parts, and as what has been said is sufficient to [236 U.S. 1, 32] dispose of the present case, we are not called upon to consider other and independent provisions of the act, such, for instance, as the provisions relating to arbitration. This decision is therefore restricted to the question of the validity of the particular provision in the act of Congress making it a crime against the United States for an agent or officer of an interstate carrier to discharge an employee from its service because of his being a member of a labor organization.' (Italics mine.)

In view of the feature of the statute involved, the charge made, and this express reservation in the opinion of the court as to other features of the statute, I am unable to agree that that case involved or decided the one now at bar.

There is nothing in the statute now under consideration which prevents an employer from discharging one in his service at his will. The question now presented is, May an employer, as a condition of present or future employment, require an employee to agree that he will not exercise the privilege of becoming a member of a labor union, should he see fit to do so? In my opinion, the cases are entirely different, and the decision of the questions controlled by different principles. The right to join labor unions is undisputed, and has been the subject of frequent affirmation in judicial opinions. Acting within their legal rights, such associations are as legitimate as any organization of citizens formed to promote their common interest. They are organized under the laws of many states, by virtue of express statutes passed for that purpose, and, being legal, and acting within their constitutional rights, the right to join them, as against coercive action to the contrary, may be the legitimate subject of protection in the exercise of the police authority of the states. This statute, passed in the exercise of that particular authority called the police power, the Limitations of which no court has yet undertaken precisely to define, has for its avowed [236 U.S. 1, 33] purpose the protection of the exercise of a legal right, by preventing an employer from depriving the employee of it as a condition of obtaining employment. I see no reason why a state may not, if it chooses, protect this right, as well as other legal rights.

But it is said that the contrary must necessarily result, if not from the precise matter decided in the Adair Case, then from the principles therein laid down, and that it is the logical result of that decision that the employer may, as a condition of employment, require an obligation to forego the exercise of any privileges because of the exercise of which an employee might be discharged from service. I do not concede that this result follows from anything decided in the Adair Case. That case dealt solely with the right of an employer to terminate relations of employment with an employee, and involved the constitutional protection of his right so to do, but did not deal with the conditions which he might exact or impose upon another as a condition of employment.

The act under consideration is said to have the effect to deprive employers of a part of their liberty of contract, for the benefit of labor organizations. It is urged that the statute has no object or purpose,

express or implied, that has reference to health, safety, morals, or public welfare, beyond the supposed desirability of leveling inequalities of fortune by depriving him who has property of some part of his 'financial independence.'

But this argument admits that financial independence is not independence of law or of the authority of the legislature to declare the policy of the state as to matters which have a reasonable relation to the welfare, peace, and security of the community.

This court has many times decided that the motives of legislators in the enactment of laws are not the subject of judicial inquiry. Legislators, state and Federal, are entitled to the presumption that their action has been in [236 U.S. 1, 34] good faith and because of conditions which they deem proper and sufficient to warrant the action taken. Speaking for this court in Ex parte McCardle, 7 Wall. 506, 514, 19 L. ed. 264, 265, Chief Justice Chase summed up the doctrine in a sentence when he said: 'We are not at liberty to inquire into the motives of the legislature; we can only examine into its power under the Constitution.' In Cooley's Constitutional Limitations, 7th ed. 257, that eminent author says: 'They [the courts] must assume that legislative discretion has been properly exercised. If evidence was required, it must be supposed that it was before the legislature when the act was passed; and if any special finding was required to warrant the passage of the particular act, it would seem that the passage of the act itself might be held equivalent to such finding.' 'The rule is general with reference to the enactments of all legislative bodies that the courts cannot inquire into the motives of the legislators in passing them, except as they may be disclosed on the face of the acts, or inferable from their operation, considered with reference to the condition of the country and existing legislation. The motives of the legislators, considered as the purposes they had in view, will always be presumed to be to accomplish that which follows as the natural and reasonable effect of their enactments. Their motives, considered as the moral inducements for their votes, will vary with the different members of the legislative body. The diverse character of such motives, and the impossibility of penetrating into the hearts of men and ascertaining the truth, precludes all such inquiries as impracticable and futile.' Soon Hing v. Crowley, 113 U.S. 703, 710 , 28 S. L. ed. 1145, 1147, 5 Sup. Ct. Rep. 730. 'We must assume that the legislature acts according to its judgment for the best interests of the state. A wrong intent cannot be imputed to it.' Florida C. & P. R. Co. v. Reynolds, 183 U.S. 471, 480 , 46 S. L. ed. 283, 287, 22 Sup. Ct. Rep. 176.

The act must be taken as an attempt of the legislature to enact a statute which it deemed necessary to the good [236 U.S. 1, 35] order and security of society. It imposes a penalty for 'coercing or influencing or making demands upon or requirements of employees, servants, laborers, and persons seeking employment.' It was in the light of this avowed purpose that the act was interpreted by the supreme court of Kansas, the ultimate authority upon the meaning of the terms of the law. Of course, if the act is necessarily arbitrary and therefore unconstitutional, mere declarations of good intent cannot save it, but it must be presumed to have been passed by the legislative branch of the state government in good faith, and for the purpose of reaching the desired end. The legislature may have believed, acting upon conditions known to it, that the public welfare would be promoted by the enactment of a statute which should prevent the compulsory exaction of written agreements to forego the acknowledged legal right here involved, as a condition of employment in one's trade or occupation.

It would be impossible to maintain that because one is free to accept or refuse a given employment, or because one may at will employ or refuse to employ another, it follows that the parties have a constitutional right to insert in an agreement of employment any stipulation they choose. They cannot put in terms that are against public policy either as it is deemed by the courts to exist at common law, or as it may be declared by the legislature as the arbiter within the limits of reason of the public policy of the state. It is no answer to say that the greater includes the less, and that because the employer is free to employ, or the employee to refuse employment, they may agree as they please. This matter is easily

tested by assuming a contract of employment for a year and the insertion of a condition upon which the right of employment should continue. The choice of such conditions is not to be regarded as wholly unrestricted because the parties may agree or not, as they choose. And if the state may pro- [236 U.S. 1, 36] hibit a particular stipulation in an agreement because it is deemed to be opposed in its operation to the security and well being of the community, it may prohibit it in any agreement, whether the employment is for a term or at will. It may prohibit the attempt in any way to bind one to the objectionable undertaking.

Would anyone contend that the state might not prohibit the imposition of conditions which should require an agreement to forego the right on the part of the employee to resort to the courts of the country for redress in the case of disagreement with his employer? While the employee might be discharged in case he brought suit against an employer if the latter so willed, it by no means follows that he could be required, as a condition of employment, to forego a right so obviously fundamental as the one supposed. It is therefore misleading to say that the right of discharge necessarily embraces the right to impose conditions of employment which shall include the surrender of rights which it is the policy of the state to maintain.

Take another illustration: The right to exclude a foreign corporation from carrying on a purely domestic business in the state has been distinctly recognized by decisions of this court; yet it has been held, and is now settled law, that it is beyond the authority of the state to require a corporation doing business of this character to file in the office of the secretary of state a written agreement that it will not remove a suit, otherwise removable, to a Federal court of the United States. Home Ins. Co. v. Morse, 20 Wall. 445, 22 L. ed. 365. In that case, the right to exclude was held not to include the right to impose any condition under which the corporation might do business in the state. In that connection this court said:

> 'A man may not barter away his life or his freedom, or his substantial rights. In a criminal case, he cannot, as was held in Cancemi's Case, 18 N. Y. 128, be tried, in any other manner than by a jury of twelve men, although he consent in open [236 U.S. 1, 37] court to be tried by a jury of eleven men. In a civil case he may submit his particular suit by his own consent to an arbitration, or to the decision of a single judge. So he may omit to exercise his right to remove his suit to a Federal tribunal, as often as he thinks fit, in each recurring case. In these aspects any citizen may, no doubt, waive the rights to which he may be entitled. He cannot, however, bind himself in advance by an agreement, which may be specifically enforced, thus to forfeit his rights at all times and on all occasions, whenever the case may be presented.' Home Ins. Co. v. Morse, 20 Wall. 445, 451, 22 L. ed. 365, 368.

It may be that an employer may be of the opinion that membership of his employees in the National Guard, by enlistment in the militia of the state, may be detrimental to his business. Can it be successfully contended that the state may not, in the public interest, prohibit an agreement to forego such enlistment as against public policy? Would it be beyond a legitimate exercise of the police power to provide that an employee should not be required to agree, as a condition of employment, to forego affiliation with a particular political party, or the support of a particular candidate for office? It seems to me that these questions answer themselves. There is a real, and not a fanciful, distinction between the exercise of the right to discharge at will and the imposition of a requirement that the employee, as a condition of employment, shall make a particular agreement to forego a legal right. The agreement may be, or may be declared to be, against public policy, although the right of discharge remains. When a man in discharged, the employer exercises his right to declare such action necessary because of the exigencies of his business, or as the result of his judgment for other reasons sufficient to himself. When he makes a stipulation of the character here involved essential to future employment, he is not exercising a right to discharge, and may not wish to discharge the employee when, at a [236 U.S. 1, 38]

subsequent time, the prohibited act is done. What is in fact accomplished, is that the one engaging to work, who may wish to preserve an independent right of action, as a condition of employment, is coerced to the signing of such an agreement against his will, perhaps impelled by the necessities of his situation. The state, within constitutional limitations, is the judge of its own policy and may execute it in the exercise of the legislative authority. This statute reaches not only the employed, but, as well, one seeking employment. The latter may never wish to join a labor union. By signing such agreements as are here involved he is deprived of the right of free choice as to his future conduct, and must choose between employment and the right to act in the future as the exigencies of his situation may demand. It is such contracts, having such effect, that this statute and similar ones seek to prohibit and punish as against the policy of the state.

It is constantly emphasized that the case presented is not one of coercion. But in view of the relative positions of employer and employed, who is to deny that the stipulation here insisted upon and forbidden by the law is essentially coercive? No form of words can strip it of its true character. Whatever our individual opinions may be as to the wisdom of such legislation, we cannot put our judgment in place of that of the legislature and refuse to acknowledge the existence of the conditions with which it was dealing. Opinions may differ as to the remedy, but we cannot understand upon what ground it can be said that a subject so intimately related to the welfare of society is removed from the legislative power. Wherein is the right of the employer to insert this stipulation in the agreement any more sacred than his right to agree with another employer in the same trade to keep up prices? He may think it quite as essential to his 'financial independence,' and so in truth it may be if he alone is to be considered. But it is too late to deny that the legis- [236 U.S. 1, 39] lative power reaches such a case. It would be difficult to select any subject more intimately related to good order and the security of the community than that under consideration-whether one takes the view that labor organizations are advantageous or the reverse. It is certainly as much a matter for legislative consideration and action as contracts in restraint of trade.

It is urged that a labor organization-a voluntary association of working men-has the constitutional right to deny membership to any man who will not agree that during such membership he will not accept or retain employment in company with nonunion men. And it is asserted that there cannot be one rule of liberty for the labor organization and its members and a different and more restrictive rule for employers.

It, of course, is true, for example, that a church may deny membership to those who unite with other denominations, but it by no means follows that the state may not constitutionally prohibit a railroad company from compelling a working-man to agree that he will, or will not, join a particular church. An analogous case, viewed from the employer's standpoint, would be: Can the state, in the exercise of its legislative power, reach concerted effort of employees, intended to coerce the employer as a condition of hiring labor, that he shall engage in writing to give up his privilege of association with other employers in legal organizations, corporate or otherwise, having for their object a united effort to promote by legal means that which employers believe to be for the best interest of their business?

I entirely agree that there should be the same rule for employers and employed, and the same liberty of action for each. In my judgment, the law may prohibit coercive attempts, such as are here involved, to deprive either of the free right of exercising privileges which are theirs within the law. So far as I know, no law has undertaken [236 U.S. 1, 40] to abridge the right of employers of labor in the exercise of free choice as to what organizations they will form for the promotion of their common interests, or denying to them free right of action in such matters.

But it is said that in this case all that was done in effect was to discharge an employee for a cause

deemed sufficient to the employer,-a right inherent in the personal liberty of the employer protected by the Constitution. This argument loses sight of the real purpose and effect of this and kindred statutes. The penalty imposed is not for the discharge, but for the attempt to coerce an unwilling employee to agree to forego the exercise of the legal right involved as a condition of employment. It is the requirement of such agreements which the state declares to be against public policy.

I think that the act now under consideration, and kindred ones, are intended to promote the same liberty of action for the employee, as the employer confessedly enjoys. The law should be as zealous to protect the constitutional liberty of the employee as it is to guard that of the employer. A principal object of this statute is to protect the liberty of the citizen to make such lawful affiliations as he may desire with organizations of his choice. It should not be necessary to the protection of the liberty of one citizen that the same right in another citizen be abridged or destroyed.

If one prohibitive condition of the sort here involved may be attached, so may others, until employment can only be had as the result of written stipulations, which shall deprive the employee of the exercise of legal rights which are within the authority of the state to protect. While this court should, within the limitations of the constitutional guaranty, protect the free right of contract, it is not less important that the state be given the right to exert its legislative authority, if it deems best to do so, for the protection of rights which inhere in the privileges of the citizen of every free country. [236 U.S. 1, 41] The supreme court of Kansas, in sustaining this statute, said that 'employees, as a rule, are not financially able to be as independent in making contracts for the sale of their labor as are employers in making a contract of purchase thereof,' and in reply to this it is suggested that the law cannot remedy inequalities of fortune, and that so long as the right of property exists, it may happen that parties negotiating may not be equally unhampered by circumstances.

This view of the Kansas court, as to the legitimacy of such considerations, is in entire harmony, as I understand it, with the former decisions of this court in considering the right of state legislatures to enact laws which shall prevent the undue or oppressive exercise of authority in making contracts with employees. In Holden v. Hardy, 169 U.S. 366 , 42 L. ed. 780, 18 Sup. Ct. Rep. 383, this court, considering legislation limiting the number of hours during which laborers might be employed in a particular employment, said:

> 'The legislature has also recognized the fact, which the experience of legislators in many states has corroborated, that the proprietors of these establishments and their operatives do not stand upon an equality, and that their interests are, to a certain extent, conflicting. The former naturally desire to obtain as much labor as possible from their employees, while the latter are often induced by the fear of discharge to conform to regulations which their judgment, fairly exercised, would pronounce to be detrimental to their health or strength. In other words, the proprietors lay down the rules and the laborers are practically constrained to obey them. In such cases self-interest is often an unsafe guide, and the legislature may properly interpose its authority. . . . But the fact that both parties are of full age and competent to contract does not necessarily deprive the state of the power to interfere where the parties do not stand upon an equality, or where the public health demands that one party to [236 U.S. 1, 42] the contract shall be protected against himself. 'The state still retains an interest in his welfare, however reckless he may be. The whole is no greater than the sum of all the parts, and when the individual health, safety and welfare are sacrificed or neglected, the state must suffer." (Page 397.)

This language was quoted with approval in Chicago, B. & Q. R. Co. v. McGuire, 219 U.S. 549, 570 , 55 S. L. ed. 328, 339, 31 Sup. Ct. Rep. 259, in which a statute of Iowa was sustained, prohibiting contracts limiting liability for injuries, made in advance of the injuries received, and providing that the

subsequent acceptance of benefits under such contracts should not constitute satisfaction for injuries received after the contract. Certainly it can be no substantial objection to the exercise of the police power that the legislature has taken into consideration the necessities, the comparative ability, and the relative situation of the contracting parties. While all stand equal before the law, and are alike entitled to its protection, it ought not to be a reasonable objection that one motive which impelled an enactment was to protect those who might otherwise be unable to protect themselves.

I therefore think that the statute of Kansas, sustained by the supreme court of the state, did not go beyond a legitimate exercise of the police power, when it sought, not to require one man to employ another against his will, but to put limitations upon the sacrifice of rights which one man may exact from another as a condition of employment. Entertaining these views, I am constrained to dissent from the judgment in this case.

I am permitted to say that Mr. Justice Hughes concurs in this dissent.

Footnotes

[Footnote 1] Constitution of the state of Kansas.

. . . Bill of Rights.

Section 1. All men are possessed of equal and inalienable natural rights, among which are life, liberty, and the pursuit of happiness.

...

Section 18. All persons, for injuries suffered in person, reputation, or property, shall have remedy by due course of law, and justice administered without delay.

[Footnote 2] Statutes like the Kansas statute have been passed in California, Colorado, Connecticut, Indiana, Massachusetts, Minnesota, New Hampshire, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, Porto Rico, and Wisconsin. Bulletin of the Bureau of Labor Statistics No. 148, volumes 1 and 2; Labor Laws of the United States.

U.S. Supreme Court

ADAIR v. U S, 208 U.S. 161 (1908)

208 U.S. 161

WILLIAM ADAIR, Plff. in Err.,
v.
UNITED STATES.
No. 293.

Argued October 29, 30, 1907.
Decided January 27, 1908.

[208 U.S. 161, 162] Messrs. Benjamin D. Warfield and Henry L. Stone for plaintiff in error.

[208 U.S. 161, 163] Attorney General Bonaparte and Mr. William R. Harr for defendant in error.

[208 U.S. 161, 166]

Mr. Justice Harlan delivered the opinion of the court:

This case involves the constitutionality of certain provisions of the act of Congress of June 1st, 1898 (30 Stat. at L. 424, chap. 370, U. S. Comp. Stat. 1901, p. 3205), [208 U.S. 161, 167] concerning carriers engaged in interstate commerce and their employees.

By the 1st section of the act it is provoided: 'That the provisions of this act shall apply to any common carrier or carriers and their officers, agents, and employees, except masters of vessels and seamen, as defined in section 4612, Revised Statutes of the United States (U. S. Comp. Stat. 1901, p. 3120), engaged in the transportation of passengers or property wholly by railroad, or partly by railroad and

partly by water, for a continuous carriage or shipment from one state or territory of the United States, or the District of Columbia, to any other state or territory of the United States, or the District of Columbia, or from any place in the United States to an adjacent foreign country, or from any place in the United States through a foreign country to any other place in the United States. The term 'railroad,' as used in this act, shall include all bridges and ferries used or operated in connection with any railroad, and also all the road in use by any corporation operating a railroad, whether owned or operated under a contract, agreement, or lease; and the term 'transportation' shall include all instrumentalities of shipment or carriage. The term 'employees,' as used in this act, shall include all persons actually engaged in any capacity in train operation or train service of any description, and notwithstanding that the cars upon or in which they are employed may be held and operated by the carrier under lease or other contract: Provided, however, That this act shall not be held to apply to employees of street railroads, and shall apply only to employees engaged in railroad train service. In every such case the carrier shall be responsible for the acts and defaults of such employees, in the same manner and to the same extent as if said cars were owned by it and said employees directly employed by it, and any provisions to the contrary of any such lease or other contract shall be binding only as between the parties thereto, and shall not affect the obligations of said carrier either to the public or to the private parties concerned.' [208 U.S. 161, 168] The 2d, 3d, 4th, 5th, 6th, 7th, 8th, and 9th sections relate to the settlement, by means of arbitration, of controversies concerning wages, hours of labor, or conditions of employment, arising between a carrier subject to the provisions of the act and its employees, which seriously interrupt, or threaten to interrupt, the business of the carrier. Those sections prescribe the mode in which controversies may be brought under the cognizance of arbitrators, in what way the arbitrators may be designated, and the effect of their decisions. The first subdivision of 3 contains a proviso 'that no employee shall be compelled to render personal service without his consent.'

The 11th section relates to the compensation and expenses of the arbitrators.

By the 12th section the act of Congress of October 1st, 1888 [25 Stat. at L. 501, chap. 1063], creating boards of arbitrators or commissioners for settling controversies and differences between railroad corporations and other common carriers engaged in interstate or territorial transportation of persons or property and their employees, was repealed.

The 10th section, upon which the present prosecution is based, is in these words:

> 'That any employers subject to the provisions of this act, and any officer, agent, or receiver of such employer, who shall require any employee, or any person seeking employment, as a condition of such employment, to enter into an agreement, either written or verbal, not to become or remain a member of any labor corporation, association, or organization; or shall threaten any employee with loss of employment, or shall unjustly discriminate against any employee because of his membership in such a labor corporation, association, or organization; who shall require any employee or any person seeking employment, as a condition of such employment, to enter into a contract whereby such employee or applicant for employment shall agree to contribute to any fund for charitable, social, or beneficial purposes; to release such employer from legal liability for any personal injury by reason of any benefit received from [208 U.S. 161, 169] such fund beyond the proportion of the benefit arising from the employer's contribution to such fund; or who shall, after having discharged an employee, attempt or conspire to prevent such employee from obtaining employment, or who shall, after the quitting of an employee, attempt or conspire to prevent such employee from obtaining employment, is hereby declared to be guilty of a misdemeanor, and, upon conviction thereof in any court of the United States of competent jurisdiction in the district in which such offense was committed, shall be punished for each offense by a fine of not less than one hundred dollars and not more than one thousand dollars.'

It may be observed in passing that while that section makes it a crime against the United States to unjustly discriminate against an employee of an interstate carrier because of his being a member of a labor organization, it does not make it a crime to unjustly discriminate against an employee of the carrier because of his not being a member of such an organization.

The present indictment was in the district court of the United States for the Eastern district of Kentucky against the defendant, Adair.

The first count alleged 'that at and before the time hereinafter named the Louisville & Nashville Railroad Company is and was a railroad corporation, duly organized and existing by law, and a common carrier engaged in the transportation of passengers and property wholly by steam railroad for a continuous carriage and shipment from one state of the United States to another state of the United States of America; that is to say, from the state of Kentucky into the States of Ohio, Indiana, and Tennessee, and from the state of Ohio into the state of Kentucky, and was, at all times aforesaid, and at the time of the commission of the offense hereinafter named, a common carrier of interstate commerce, and an employer, subject to the provisions of a certain act of Congress of the United States of America, entitled, 'An Act Concerning Carriers Engaged in Interstate Commerce and Their Employees,' approved June 1st, 1898, and said corporation was not at any [208 U.S. 161, 170] time a street railroad corporation. That before and at the time of the commission of the offense hereinafter named one William Adair was an agent and employee of said common carrier and employer, and was, at all said times, master mechanic of said common carrier and employer in the district aforesaid, and before and at the time hereinafter stated one O. B. Coppage was an employee of said common carrier and employer in the district aforesaid, and as such employee was, at all times hereinafter named, actually engaged in the capacity of locomotive fireman in train operation and train service for said common carrier and employer in the transportation of passengers and property aforesaid, and was an employee of said common carrier and employer actually engaged in said railroad transportation and train service aforesaid, to whom the provisions of said act applied, and at the time of the commission of the offense hereinafter named said O. B. Coppage was a member of a certain labor organization, known as the Order of Locomotive Firemen, as he, the said William Adair, then and there well knew; a more particular description of said organization and the members thereof is to the grand jurors unknown.'

The specific charge in that count was 'that said William Adair, agent and employee of said common carrier and employer. as aforesaid, in the district aforesaid, on and before the 15th day of October, 1906, did unlawfully and unjustly discriminate against said O. B. Coppage, employee, as aforesaid, by then and there discharging said O. B. Coppage from such employment of said common carrier and employer, because of his membership in said labor organization, and thereby did unjustly discriminate against an employee of a common carrier and employer engaged in interstate commerce because of his membership in a labor organization, contrary to the forms of the statute in such cases made and provided, and against the peace and dignity of the United States.'

The second count repeated the general allegations of the first count as to the character of the business of the Louisville [208 U.S. 161, 171] & Nashville Railroad Company and the relations between that corporation and Adair and Coppage. It charged 'that said William Adair, in the district aforesaid, and within the jurisdiction of this court, agent and employee of said common carrier and employer aforesaid, on and before the 15th day of October, 1906, did unlawfully threaten said O. B. Coppage, employee as aforesaid, with loss of employment, because of his membership in said labor organization, contrary to the forms of the statute in such cases made and provided, and against the peace and dignity of the United States.'

The accused, Adair, demurred to the indictment as insufficient in law, but the demurrer was overruled.

After reviewing the authorities, in an elaborate opinion, the court held the 10th section of the act of Congress to be constitutional. 152 Fed. 737. The defendant pleaded not guilty, and after trial a verdict was returned of guilty on the first count and a judgment rendered that he pay to the United States a fine of $100. We shall, therefore, say nothing as to the second count of the indictment.

It thus appears that the criminal offense charged in the count of the indictment upon which the defendant was convicted was, in substance and effect, that, being an agent of a railroad company engaged in interstate commerce, and subject to the provisions of the above act of June 1st, 1898, he discharged one Coppage from its service because of his membership in a labor organization,-no other ground for such discharge being alleged.

May Congress make it a criminal offense against the United States-as, by the 10th section of the act of 1898, it does-for an agent or officer of an interstate carrier, having full authority in the premises from the carrier, to discharge an employee from service simply because of his membership in a labor organization?

This question is admittedly one of importance, and has been examined with care and deliberation. And the court has reached a conclusion which, in its judgment, is consistent [208 U.S. 161, 172] with both the words and spirit of the Constitution, and is sustained as well by sound reason.

The first inquiry is whether the part of the 10th section of the act of 1898 upon which the first count of the indictment was based is repugnant to the 5th Amendment of the Constitution, declaring that no person shall be deprived of liberty or property without due process of law. In our opinion that section, in the particular mentioned, is an invasion of the personal liberty, as well as of the right of property, guaranteed by that Amendment. Such liberty and right embrace the right to make contracts for the purchase of the labor of others, and equally the right to make contracts for the sale of one's own labor; each right, however, being subject to the fundamental condition that no contract, whatever its subject-matter, can be sustained which the law, upon reasonable grounds, forbids as inconsistent with the public interests, or as hurtful to the public order, or as detrimental to the common good. This court has said that 'in every well-ordered society, charged with the duty of conserving the safety of its members, the rights of the individual in respect of his liberty may, at times, under the pressure of great dangers, be subjected to such restraint, to be enforced by reasonable regulations, as the safety of the general public may demand.' Jacobson v. Massachusetts, 197 U.S. 11, 29 , 49 S. L. ed. 643, 651, 25 Sup. Ct. Rep. 358, 362, and authorities there cited. Without stopping to consider what would have been the rights of the railroad company under the 5th Amendment, had it been indicted under the act of Congress, it is sufficient in this case to say that, as agent of the railroad company, and, as such, responsible for the conduct of the business of one of its departments, it was the defendant Adair's right-and that right inhered in his personal liberty, and was also a right of property-to serve his employer as best he could, so long as he did nothing that was reasonably forbidden by law as injurious to the public interests. It was the right of the defendant to prescribe the terms upon which the services of Coppage would be accepted, and it was the right of Coppage to become or not, [208 U.S. 161, 173] as he chose, an employee of the railroad company upon the terms offered to him. Mr. Cooley, in his treatise on Torts, p. 278, well says: 'It is a part of every man's civil rights that he be left at liberty to refuse business relations with any person whomsoever, whether the refusal rests upon reason, or is the result of whim, caprice,prejudice, or malice. With his reasons neither the public nor third persons have any legal concern. It is also his right to have business relations with anyone with whom he can make contracts, and, if he is wrongfully deprived of this right by others, he is entitled to redress.'

In Lochner v. New York, 198 U.S. 45, 53 , 56 S., 49 L. ed. 937, 940, 941, 25 Sup. Ct. Rep. 539, 541, 543, which involved the validity of a state enactment prescribing certain maximum hours for labor in

bakeries, and which made it a misdemeanor for an employer to require or permit an employee in such an establishment to work in excess of a given number of hours each day, the court said: 'The general right to make a contract in relation to his business is part of the liberty of the individual protected by the 14th Amendment of the Federal Constitution. Allgeyer v. Louisiana, 165 U.S. 578 , 41 L. ed. 832, 17 Sup. Ct. Rep. 427. Under that provision no state can deprive any person of life, liberty, or property without due process of law. The right to purchase or to sell labor is part of the liberty protected by this Amendment, unless there are circumstances which exclude the right. There are, however, certain powers existing in the sovereignty of each state in the Union, somewhat vaguely termed 'police powers,' the exact description and limitation of which have not been attempted by the courts. Those powers, broadly stated, and without, at present, any attempt at a more specific limitation, relate to the safety, health, morals, and general welfare of the public. Both property and liberty are held on such reasonable conditions as may be imposed by the governing power of the state in the exercise of those powers, and with such conditions the 14th Amendment was not designed to interfere. Mugler v. Kansas, 123 U.S. 623 , 31 L. ed. 205, 8 Sup. Ct. Rep. 273; Re Kemmler, 136 U.S. 436 , 34 L. ed. 519, 10 Sup. Ct. Rep. 930; Crowley v. Christensen, 137 U.S. 86 , 34 L. ed. 620, 11 Sup. Ct. Rep. 13; Re Converse, 137 U.S. 624 , 34 L. ed. 796, 11 Sup. Ct. Rep. 191. . . . In every case that [208 U.S. 161, 174] comes before this court, therefore, where legislation of this character is concerned, and where the protection of the Federal Constitution is sought, the question necessarily arises: Is this a fair, reasonable, and appropriate exercise of the policepower of the state, or is it an unreasonable, unnecessary, and arbitrary interference with the right of the individual to his personal liberty or to enter into those contracts in relation to labor which may seem to him appropriate or necessary for the support of himself and his family? Of course, the liberty of contract relating to labor includes both parties to it. The one has as much right to purchase as the other to sell labor.' Although there was a difference of opinion in that case among the members of the court as to certain propositions, there was no disagreement as to the general proposition that there is a liberty of contract which cannot be unreasonably interfered with by legislation. The minority were of opinion that the business referred to in the New York statute was such as to require regulation, and that, as the statute was not shown plainly and palpably to have imposed an unreasonable restraint upon freedom of contract, it should be regarded by the courts as a valid exercise of the state's power to care for the health and safety of its people.

While, as already suggested, the right of liberty and property guaranteed by the Constitution against deprivation without due process of law is subject to such reasonable restraints as the common good or the general welfare may require, it is not within the functions of government- at least, in the absence of contract between the parties-to compel any person, in the course of his business and against his will, to accept or retain the personal services of another, or to compel any person, against his will, to perform personal services for another. The right of a person to sell his labor upon such terms as he deems proper is, in its essence, the same as the right of the purchaser of labor to prescribe the conditions upon which he will accept such labor from the person offering to sell it. So the right of the employee to quit the service of the employer, [208 U.S. 161, 175] for whatever reason, is the same as the right of the employer, for whatever reason, to dispense with the services of such employee. It was the legal right of the defendant, Adair,-however unwise such a course might have been,-to discharge Coppage because of his being a member of a labor organization, as it was the legal right of Coppage, if he saw fit to do so,-however unwise such a course on his part might have been,-to quit the service in which he was engaged, because the defendant employed some persons who were not members of a labor organization. In all such particulars the employer and the employee have equality of right, and any legislation that disturbs that equality is an arbitrary interference with the liberty of contract which no government can legally justify in a free land. These views find support in adjudged cases, some of which are cited in the margin. Of course, if the parties by contract fixed the period of service, and prescribed the conditions upon which the contract may be terminated, such contract would control the rights of the parties as between themselves, and for any violation of those provisions the party wronged would have his appropriate civil action. And it may be-but upon that point we express no opinion-that, in the case of a

labor contract between an employer engaged in interstate commerce and his employee, Congress could make it a crime for either party, without sufficient or just excuse or notice, to disregard the terms of such contract or to refuse to perform it. In the absence, however, of a valid contract between the parties controlling their conduct towards each other and fixing a period of service, it cannot be, we repeat, that an employer is under any legal obligation, against his will, to retain an employee in his personal service any more than an employee

People v. Marcus, 185 N. Y. 257, 7 L.R.A.(N.S.) 282, 113 Am. St. Rep. 902, 77 N. E. 1073; National Protective Asso. v. Cumming, 170 N. Y. 315, 58 L.R.A. 135, 88 Am. St. Rep. 648, 63 N. E. 369; Jacobs v. Cohen, 183 N. Y. 207, 2 L.R.A.(N.S.) 292, 111 Am. St. Rep. 730, 76 N. E. 5; State v. Julow, 129 Mo. 163, 29 L.R.A. 257, 50 Am. St. Rep. 443, 31 S. W. 781; State v. Goodwill, 33 W. Va. 179, 6 L.R.A. 621, 25 Am. St. Rep. 863, 10 S. E. 285; Gillespie v. People, 188 Ill. 176, 52 L.R.A. 283, 80 Am. St. Rep. 176, 58 N. E. 1007; State ex rel. Zillmer v. Kreutzberg, 114 Wis. 530, 58 L.R.A. 748, 91 Am. St. Rep. 934, 90 N. W. 1098; Wallace v. Georgia, C. & N. R. Co. 94 Ga. 732, 22 S. E. 579; Hundley v. Louisville & N. R. Co. 105 Ky. 162, 63 L.R.A. 289, 88 Am. St. Rep. 298, 48 S. W. 429; Brewster v. C. Miller's Sons Co. 101 Ky. 368, 38 L.R.A. 505, 41 S. W. 301; New York, C. & St. L. R. Co. v. Schaffer, 65 Ohio St. 414, 62 L.R.A. 931, 87 Am. St. Rep. 628, 62 N. E. 1036; Arthur v. Oakes, 25 L.R.A. 414, 4 Inters. Com. Rep. 744, 11 C. C. A. 209, 24 U. S. App. 239, 63 Fed. 310. [208 U.S. 161, 176] can be compelled, against his will, to remain in the personal service of another. So far as this record discloses the facts the defendant, who seemed to have authority in the premises, did not agree to keep Coppage in service for any particular time, nor did Coppage agree to remain in such service a moment longer than he chose. The latter was at liberty to quit the service without assigning any reason for his leaving. And the defendant was at liberty, in his discretion, to discharge Coppage from service without giving any reason for so doing.

As the relations and the conduct of the parties towards each other was not controlled by any contract other than a general employment on one side to accept the services of the employee and a general agreement on the other side to render services to the employer,-no term being fixed for the continuance of the employment,-Congress could not, consistently with the 5th Amendment, make it a crime against the United States to discharge the employee because of his being a member of a labor organization.

But it is suggested that the authority to make it a crime for an agent or officer of an interstate carrier, having authority in the premises from his principal, to discharge an employee from service to such carrier, simply because of his membership in a labor organization, can be referred to the power of Congress to regulate interstate commerce, without regard to any question of personal liberty or right of property arising under the 5th Amendment. This suggestion can have no bearing in the present discussion unless the statute, in the particular just stated, is, within the meaning of the Constitution, a regulation of commerce among the states. If it be not, then clearly the government cannot invoke the commerce clause of the Constitution as sustaining the indictment against Adair.

Let us inquire what is commerce, the power to regulate which is given to Congress?

This question has been frequently propounded in this court, and the answer has been-and no more specific answer could [208 U.S. 161, 177] well have been given-that commerce among the several states comprehends traffic, intercourse, trade, navigation, communication, the transit of persons, and the transmission of messages by telegraph,-indeed, every species of commercial intercourse among the several states,-but not that commerce 'completely internal, which is carried on between man and man, in a state, or between different parts of the same state, and which does not extend to or affect other states.' The power to regulate interstate commerce is the power to prescribe rules by which such commerce must be governed. Of course, as has been often said, Congress has a large discretion in the selection or

choice of the means to be employed in the regulation of interstate commerce, and such discretion is not to be interfered with except where that which is done is in plain violation of the Constitution. Northern Securities Co. v. United States, 193 U.S. 197 , 48 L. ed. 679, 24 Sup. Ct. Rep. 436, and authorities there cited. In this connection we may refer to Johnson v. Southern P. Co. 196 U.S. 1 , 49 L. ed. 363, 25 Sup. Ct. Rep. 158, relied on in argument, which case arose under the act of Congress of March 2d, 1893 (27 Stat. at L. 531, chap. 196, U. S. Comp. Stat. 1901, p. 3174). That act required carriers engaged in interstate commerce to equip their cars used in such commerce with automatic couplers and continuous brakes, and their locomotives with driving-wheel brakes. But the act upon its face showed that its object was to promote the safety of employees and travelers upon railroads; and this court sustained its validity upon the ground that it manifestly had reference to interstate commerce, and was calculated to subserve the interests of such commerce by affording protection to employees and travelers. It was held that there was a substantial connection between the object sought to be attained by the act and the means provided to accomplish that object. So, in regard to Howard v. Illinois C. R. Co. decided at the present term.

Gibbons v. Ogden, 9 Wheat. 1, 6 L. ed. 23; Passenger Cases, 7 How. 283, 12 L. ed. 702; Almy v. California, 24 How. 169, 16 L. ed. 644; Pensacola Teleg. Co. v. Western U. Teleg. Co. 96 U.S. 1, 9 , 12 S., 24 L. ed. 708, 710, 711; Mobile County v. Kimball, 102 U.S. 691 , 26 L. ed. 238; Western U. Teleg. Co. v. Pendleton, 122 U.S. 347, 356 , 30 S. L. ed. 1187, 1188, 1 Inters. Com. Rep. 306, 7 Sup. Ct. Rep. 1126; Lottery Case (Champion v. Ames) 188 U.S. 321, 352 , 47 S. L. ed. 492, 499, 23 Sup. Ct. Rep. 321; Northern Securities Co. v. United States, 193 U.S. 197 , 48 L. ed. 679, 24 Sup. Ct. Rep. 436; Howard v. Illinois C. R. Co. (present term) 207 U.S. 463 , ante, 141, 28 Sup. Ct. Rep. 141. [208 U.S. 161, 178] 207 U.S. 463 , ante, 141, 28 Sup. Ct. Rep. 141. In that case the court sustained the authority of Congress, under its power to regulate interstate commerce, to prescribe the rule of liability, as between interstate carriers and its employees in such interstate commerce, in cases of personal injuries received by employees while actually engaged in such commerce. The decision on this point was placed on the ground that a rule of that character would have direct reference to the conduct of interstate commerce, and would, therefore, be within the competency of Congress to establish for commerce among the states, but not as to commerce completely internal to a state. Manifestly, any rule prescribed for the conduct of interstate commerce, in order to be within the competency of Congress under its power to regulate commerce among the states, must have some real or substantial relation to or connection with the commerce regulated. But what possible legal or logical connection is there between an employee's membership in a labor organization and the carrying on of interstate commerce? Such relation to a labot organization cannot have, in itself and in the eye of the law, any bearing upon the commerce with which the employee is connected by his labor and services. Labor associations, we assume, are organized for the general purpose of improving or bettering the conditions and conserving the interests of its members as wage-earners,-an object entirely legitimate and to be commended rather than condemned. But surely those associations, as labor organizations, have nothing to do with interstate commerce, as such. One who engages in the service of an interstate carrier will, it must be assumed, faithfully perform his duty, whether he be a member or not a member of a labor organization. His fitness for the position in which he labors and his diligence in the discharge of his duties cannot, in law or sound reason, depend in any degree upon his being or not being a member of a labor organization. It cannot be assumed that his fitness is assured, or his diligence increased, by such membership, or that he is less fit or less diligent be- [208 U.S. 161, 179] cause of his not being a member of such an organization. It is the employee as a man, and not as a member of a labor organization, who labors in the service of an interstate carrier. Will it be said that the provision in question had its origin in the apprehension, on the part of Congress, that, if it did not show more consideration for members of labor organizations than for wage-earners who were not members of such organizations, or if it did not insert in the statute some such provision as the one here in question, members of labor organizations would, by illegal or violent measures, interrupt or impair the freedom of commerce among the states? We will not indulge in any such conjectures, nor make them, in whole or in part, the basis of our decision. We could not do so consistently with the respect due to a coordinate department of the government. We could not do so without imputing to

Congress the purpose to accord to one class of wage-earners privileges withheld from another class of wage-earners, engaged, it may be, in the same kind of labor and serving the same employer. Nor will we assume, in our consideration of this case, that members of labor organizations will, in any considerable numbers, resort to illegal methods for accomplishing any particular object they have in view.

Looking alone at the words of the statute for the purpose of ascertaining its scope and effect, and of determining its validity, we hold that there is no such connection between interstate commerce and membership in a labor organization as to authorize Congress to make it a crime against the United States for an agent of an interstate carrier to discharge an employee because of such membership on his part. If such a power exists in Congress it is difficult to perceive why it might not, by absolute regulation, require interstate carriers, under penalties, to employ, in the conduct of its interstate business, only members of labor organizations, or only those who are not members of such organizations,-a power which could not be recognized as existing under the Constitution of the United States. No such rule of criminal liability as that to which [208 U.S. 161, 180] we have referred can be regarded as, in any just sense, a regulation of interstate commerce. We need scarcely repeat what this court has more than once said, that the power to regulate interstate commerce, great and paramount as that power is, cannot be exerted in violation of any fundamental right secured by other provisions of the Constitution. Gibbons v. Ogden, 9 Wheat. 1, 196, 6 L. ed. 23, 70; Lottery Case (Champion v. Ames) 188 U.S. 321, 353 , 47 S. L. ed. 492, 500, 23 Sup. Ct. Rep. 321.

It results, on the whole case, that the provision of the statute under which the defendant was convicted must be held to be repugnant to the 5th Amendment, and as not embraced by nor within the power of Congress to regulate interstate commerce, but, under the guise of regulating interstate commerce, and as applied to this case, it arbitrarily sanctions an illegal invasion of the personal liberty as well as the right of property of the defendant, Adair.

We add that since the part of the act of 1898 upon which the first count of the indictment is based, and upon which alone the defendant was convicted, is severable from its other parts, and as what has been said is sufficient to dispose of the present case, we are not called upon to consider other and independent provisions of the act, such, for instance, as the provisions relating to arbitration. This decision is therefore restricted to the question of the validity of the particular provision in the act of Congress making it a crime against the United States for an agent or officer of an interstate carrier to discharge an employee from its service because of his being a member of a labor organization.

The judgment must be reversed, with directions to set aside the verdict and judgment of conviction, sustain the demurrer to the indictment, and dismiss the case.

It is so ordered.

Mr. Justice Moody did not participate in the decision of this case.

Mr. Justice McKenna, dissenting:

The opinion of the court proceeds upon somewhat narrow [208 U.S. 161, 181] lines and either omits or does not give adequate prominence to the considerations which, I think, are determinative of the questions in the case. The principle upon which the opinion is grounded is, as I understand it, that a labor organization has no legal or logical connection with interstate commerce, and that the fitness of an employee has no dependence or relation with his membership in such organization. It is hence concluded that to restrain his discharge merely on account of such membership is an invasion of the

liberty of the carrier guaranteed by the 5th Amendment of the Constitution of the United States. The conclusion is irresistible if the propositions from which it is deduced may be viewed as abstractly as the opinion views them. May they be so viewed?

A summary of the act is necessary to understand 10. Detach that section from the other provisions of the act and it might be open to condemnation.

The 1st section of the act designates the carriers to whom it shall apply. The 2d section makes it the duty of the chairman of the Interstate Commerce Commission and the Commissioner of Labor, in case of a dispute between carriers and their employees which threatens to interrupt the business of the carriers, to put themselves in communication with the parties to the controversy and use efforts to 'mediation and conciliation.' If the efforts fail, then 3 provides for the appointment of a board of arbitration,-one to be named by the carrier, one by the labor organization to which the employees belong, and the two thus chosen shall select a third.

There is a provision that if the employees belong to different organizations they shall concur in the selection of the arbitrator. The board is to give hearings; power is vested in the board to summon witnesses, and provision is made for filing the award in the clerk's office of the circuit court of the United States for the district where the controversy arose. Others sections complete the scheme of arbitration thus outlined, and make, as far as possible, the proceedings of the arbitrators [208 U.S. 161, 182] judicial, and, pending them, put restrictions on the parties, and damages for violation of the restrictions.

Even from this meager outline may be perceived the justification and force of 10. It prohibits discrimination by a carrier engaged in interstate commerce, in the employment under the circumstances hereafter mentioned, or the discharge from employment of members of labor organizations 'because of such membership.' This the opinion condemns. The actions prohibited, it is asserted, are part of the liberty of a carrier, protected by the Constitution of the United States from limitation or regulation. I may observe that the declaration is clear and unembarrassed by any material benefit to the carrier from its exercise. It may be exercised with reason or without reason, though the business of the carrier is of public concern. This, then, is the contention, and I bring its elements into bold relief to submit against them what I deem to be stronger considerations, based on the statute and sustained by authority.

I take for granted that the expressions of the opinion of the court, which seems to indicate that the provisions of 10 are illegal because their violation is made criminal, are used only for description and incidental emphasis, and not as the essential ground of the objections to those provisions.

I may assume at the outset that the liberty guaranteed by the 5th Amendment is not a liberty free from all restraints and limitations, and this must be so or government could not be beneficially exercised in many cases. Therefore, in judging of any legislation which imposes restraints or limitations, the inquiry must be, What is their purpose, and is the purpose within one of the powers of government? Applying this principle immediately to the present case, without beating about in the abstract, the inquiry must be whether 10 of the act of Congress has relation to the purpose which induced the act, and which it was enacted to accomplish, and whether such purpose is in aid of interstate commerce, and not a mere restriction upon the liberty of carriers to employ whom they please, or to have business relations with whom they please. In the inquiry there [208 U.S. 161, 183] is necessarily involved a definition of interstate commerce and of what is a regulation of it. As to the first, I may concur with the opinion; as to the second, an immediate and guiding light is afforded by the case of Howard v. Illinois C. R. Co., recently decided. 207 U.S. 463 , ante, 141, 28 Sup. Ct. Rep. 141. In that case there was a searching scrutiny of the powers of Congress, and it was held to be competent to establish a new rule of liability

of the carrier to his employees; in a word, competent to regulate the relation of master and servant,-a relation apparently remote from commerce, and one which was earnestly urged by the railroad to be remote from commerce. To the contention the court said: 'But we may not test the power of Congress to regulate commerce solely by abstractly considering the particular subject to which a regulation relates, irrespective of whether the regulation in question is one of interstate commerce. On the contrary, the test of power is not merely the matter regulate, but whether the regulation is directly one of interstate commerce, or is embraced within the grant conferred on Congress to use all lawful means necessary and appropriate to the execution of the power to regulate commerce.' In other words, that the power is not confined to a regulation of the mere movement of goods or persons.

And there are other examples in our decisions-examples, too, of liberty of contract and liberty of forming business relations (made conspicuous as grounds of decision in the present case)-which were compelled to give way to the power of Congress. Northern Securities Co. v. United States, 193 U.S. 200 , 48 L. ed. 679, 24 Sup. Ct. Rep. 436. In that case exactly the same definitions were made as made here and the same contentions were pressed as are pressed here. The Northern Securities Company was not a railroad company. Its corporate powers were limited to buying, selling, and holding stock, bonds, and other securities, and it was contended that, as such business was not commerce at all, it could not be within the power of Congress to regulate. The contention was not yielded to, though it had the support of members of this court. Asserting the application of the anti- [208 U.S. 161, 184] trust act of 1890 [26 Stat. at L. 209, chap. 647, U. S. Comp. Stat. 1901, p. 3200] to such business, and the power of Congress to regulate it, the court said 'that a sound construction of the Constitution allows to Congress a large discretion 'with respect to the means by which the powers it [the commerce clause] confers are to be carried into execution, which enables that body to perform the high duties assigned to it, in the manner most beneficial to the people." It was in recognition of this principle that it was declared in United States v. Joint Traffic Asso. 171 U.S. 571 , 43 L. ed. 288, 19 Sup. Ct. Rep. 25: 'The prohibition of such contracts [contracts fixing rates] may, in the judgment of Congress, be one of the reasonable necessities for the proper regulation of commerce, and Congress is the judge of such necessity and propriety, unless, in case of a possible gross perversion of the principle, the courts might be applied to for relief.' The contentions of the parties in the case invoked the declaration. There, as here, an opposition was asserted between the liberty of the railroads to contract with one another and the power of Congress to regulate commerce. That power was pronounced paramount, and it was not perceived, as it seems to be perceived now, that it was subordinate, and controlled by the provisions of the 5th Amendment. Nor was the relation of the power of Congress to that Amendment overlooked. It was commented upon and reconciled. And there is nothing whatever in Gibbons v. Ogden, 9 Wheat. 1, 6 L. ed. 23, or in Lottery Case (Champion v. Ames) 188 U.S. 321 , 47 L. ed. 492, 23 Sup. Ct. Rep. 321, which is to the contrary.

From these considerations we may pase to an inspection of the statute of which 10 is a part, and inquire as to its purpose, and if the means which it employs has relation to that purpose and to interstate commerce. The provisions of the act are explicit and present a well co-ordinated plan for the settlement of disputes between carriers and their employees, by bringing the disputes to arbitration and accommodation, and thereby prevent strikes and the public disorder and derangement of business that may be consequent upon them. I submit no worthier purpose can engage legislative attention or be the object of legislative action, and, it might be urged, [208 U.S. 161, 185] to attain which the congressional judgment of means should not be brought under a rigid limitation and condemned, if it contribute in any degree to the end, as a 'gross perversion of the principle' of regulation, the condition which, it was said in United States v. Joint Traffic Asso. supra, might justify an appeal to the courts.

We are told that labor associations are to be commended. May not, then Congress recognize their existence? yes, and recognize their power as conditions to be counted with in framing its legislation? Of what use would it be to attempt to bring bodies of men to agreement and compromise of controversies if you put out of view the influences which move them or the fellowship which binds them,-maybe

controls and impels them, whether rightfully or wrongfully, to make the cause of one the cause of all? And this practical wisdom Congress observed,-observed, I may say, not in speculation or uncertain prevision of evils, but in experience of evils,- an experience which approached to the dimensions of a national calamity. The facts of history should not be overlooked nor the course of legislation. The act involved in the present case was preceded by one enacted in 1888 of similar purport. 25 Stat. at L. 501, chap. 1063. That act did not recognize labor associations, or distinguish between the members of such associations and the other employees of carriers. It failed in its purpose, whether from defect in its provisions or other cause we may only conjecture. At any rate, it did not avert the strike at Chicago in 1894. Investigation followed, and, as a result of it, the act of 1898 was finally passed. Presumably its provisions and remedy were addressed to the mischief which the act of 1888 failed to reach or avert. It was the judgment of Congress that the scheme of arbitration might be helped by engaging in it the labor associations. Those associations unified bodies of employees in every department of the carriers, and this unity could be an obstacle or an aid to arbitration. It was attempted to be made an aid; but how could it be made an aid if, pending the efforts of 'mediation and conciliation' [208 U.S. 161, 186] of the dispute, as provided in 2 of the act, other provisions of the act may be arbitrarily disregarded, which are of concern to the members in the dispute? How can it be an aid, how can controversies which may seriously interrupt or threaten to interrupt the business of carriers (I paraphrase the words of the statute) be averted or composed if the carrier can bring on the conflict or prevent its amicable settlement by the exercise of mere whim and caprice? I say mere whim or caprice, for this is the liberty which is attempted to be vindicated as the constitutional right of the carriers. And it may be exercised in mere whim and caprice. If ability, the qualities of efficient and faithful workmanship, can be found outside of labor associations, surely they may be found inside of them. Liberty is an attractive theme, but the liberty which is exercised in sheer antipathy does not plead strongly for recognition.

There is no question here of the right of a carrier to mingle in his service 'union' and 'nonunion' men. If there were, broader considerations might exist. In such a right there would be no discrimination for the 'union' and no discrimination against it. The efficiency of an employee would be its impulse and ground of exercise.

I need not stop to conjecture whether Congress could or would limit such right. It is certain that Congress has not done so by any provision of the act under consideration. Its letter, spirit, and purpose are decidedly the other way. It imposes, however, a restraint, which should be noticed. The carriers may not require an applicant for employment or an employee to agree not to become or remain a member of a labor organization. But this does not constrain the employment of anybody, be he what he may.

But it is said it cannot be suuposed that labor organizations will, 'by illegal or violent measures, interrupt or impair the freedom of commerce,' and to so suppose would be disrespect to a co-ordinate branch of the government, and to impute to it a purpose 'to accord to one class of wage-earners privileges withheld from another class of wage-earners, engaged, it may [208 U.S. 161, 187] be, in the same kind of labor and serving the same employer.' Neither the supposition nor the disrespect is necessary, and, it may be urged, they are no more invidious than to impute to Congress a careless or deliberate or purposeless violation of the constitutional rights of the carriers. Besides, the legislation is to be accounted for. It, by its letter, makes a difference between members of labor organizations and other employees of carriers. If it did not, it would not be here for review. What did Congress mean? Had it no purpose? Was it moved by no cause? Was its legislation mere wantonness and an aimless meddling with the commerce of the country? These questions may find their answers in Re Debs, 158 U.S. 564 , 39 L. ed. 1092, 15 Sup. Ct. Rep. 900.

I have said that it is not necessary to suppose that labor organizations will violate the law, and it is not. Their power may be effectively exercised without violence or illegality, and it cannot be disrespect to

Congress to let a committee of the Senate speak for it and tell the reason and purposes of its legislation. The committee on education, in its report, said of the bill: 'The measure under consideration may properly be called a voluntary arbitration bill, having for its object the settlement of disputes between capital and labor, as far as the interstate transportation companies are concerned. The necessity for the bill arises from the calamitous results in the way of ill-considered strikes arising from the tyranny of capital or the unjust demands of labor organizations, whereby the business of the country is brought to a standstill and thousands of employees, with their helpless wives and children, are confronted with starvation.' And, concluding the report, said: 'It is our opinion that this bill, should it become a law, would reduce to a minimum labor strikes which affect interstate commerce, and we therefore recommend its passage.'

With the report was submitted a letter from the secretary of the Interstate Commerce Commission, which expressed the judgment of that body, formed, I may presume, from experience of the factors in the problem. The letter said: 'With the corporations as employers, on one side, and the organiza- [208 U.S. 161, 188] tions of railway employees, on the other, there will be a measure of equality of power and force which will surely bring about the essential requisites of friendly relation, respect, consideration, and forbearance.' And again: 'It has been shown before the labor commission of England that, where the associations are strong enough to command the respect of their employers, the relations between employer and employee seem most amicable. For there the employers have learned the practical convenience of treating with one thoroughly representative body instead of with isolated fragments of workmen; and the labor associations have learned the limitations of their powers.'

It is urged by plaintiff in error that 'there is a marked distinction between a power to regulate commerce and a power to regulate the affairs of an individual or corporation engaged in such commerce;' and how can it be, it is asked, a regulation of commerce to prevent a carrier from selecting his employees or constrainign him to keep in his service those whose loyalty to him is 'seriously impaired, if not destroyed, by their prior allegiance to their labor unions?' That the power of regulation extends to the persons engaged in interstate commerce is settled by decision. Howard v. Illinois C. R. Co. 207 U.S. 463 , ante, 141, 28 Sup. Ct. Rep. 141, and the cases cited in Mr. Justice Moody's dissenting opinion. The other proposition points to no evil or hazard of evil. Section 10 does not constrain the employment of incompetent workmen, and gives no encouragement or protection to the disloyalty of an employee or to deficiency in his work or duty. If guilty of either he may be instantly discharged without incurring any penalty under the statute.

Counsel also makes a great deal of the difference between direct and indirect effect upon interstate commerce, and assert that 10 is an indirect regulation at best, and not within the power of Congress to enact. Many cases are cited, which, it is insisted, sustain the contention. I cannot take time to review the cases. I have already alluded to the contention, and it is enough to say that it gives too much isolation to 10. [208 U.S. 161, 189] The section is part of the means to secure and make effective the scheme of arbitration set forth in the statute. The contention, besides, is completely answered by Howard v. Illinois C. R. Co. supra. In that case, as we have seen, the power of Congress was exercised to establish a rule of liability of a carrier to his employees for personal injuries received in his service. It is manifest that the kind of extent of such liability is neither traffic nor intercourse, the transit of persons nor the carrying of things. Indeed, such liability may have wider application than to carriers. It may exist in a factory; it may exist on a farm; and, in both places, or in commerce, its direct influence might be hard to find or describe. And yet this court did not hesitate to pronounce it to be within the power of Congress to establish. 'The primary object,' it was said in Johnson v. Southern P. Co. 196 U.S. 1 , 49 L. ed. 363, 25 Sup. Ct. Rep. 158, of the safety appliance act, 'was to promote the public welfare by securing the safety of employees and travelers.' The rule of liability for injuries is even more roundabout in its influence on commerce, and as much so as the prohibition of 10. To contend otherwise seems to me to be an oversight of the proportion of things. A provision of law which will prevent, or tend to prevent,

the stoppage of every wheel in every car of an entire railroad system, certainly has as direct influence on interstate commerce as the way in which one car may be coupled to another, or the rule of liability for personal injuries to an employee. It also seems to me to be an oversight of the proportions of things to contend that, in order to encourage a policy of arbitration between carriers and their employees which may prevent a disastrous interruption of commerce, the derangement of business, and even greater evils to the public welfare, Congress cannot restrain the discharge of an employee, and yet can, to enforce a policy of unrestrained competition between railroads, prohibit reasonable agreements between them as to the rates at which merchandise shall be carried. And mark the contrast of what is prohibited. In the one case the restraint, it may be, of a whim,-certainly of nothing that affects the ability of an employee to perform his [208 U.S. 161, 190] duties; nothing, therefore, which is of any material interest to the carrier,-in the other case, a restraint of a carefully-considered policy which had as its motive great material interests and benefits to the railroads, and, in the opinion of many, to the public. May such action be restricted, must it give way to the public welfare, while the other, moved, it may be, by prejudice and antagonism, is intrenched impregnably in the 5th Amendment of the Constitution against regulation in the public interest?

I would not be misunderstood. I grant that there are rights which can have no material measure. There are rights which, when exercised in a private business, may not be disturbed or limited. With them we are not concerned. We are dealing with rights exercised in a quasi public business, and therefore subject to control in the interest of the public.

I think the judgment should be affirmed.

Mr. Justice Holmes, dissenting:

I also think that the statute is constitutional, and, but for the decision of my brethren, I should have felt pretty clear about it.

As we all know, there are special labor unions of men engaged in the service of carriers. These unions exercise a direct influence upon the employment of labor in that business, upon the terms of such employment, and upon the business itself. Their very existence is directed specifically to the business, and their connection with it is, at least, as intimate and important as that of safety couplers, and, I should think, as the liability of master to servant,-matters which, it is admitted, Congress might regulate, so far as they concern commerce among the states. I suppose that it hardly would be denied that some of the relations of railroads with unions of railroad employees are closely enough connected with commerce to justify legislation by Congress. If so, legislation to prevent the exclusion of such unions from employment is sufficiently near. [208 U.S. 161, 191] The ground on which this particular law is held bad is not so much that it deals with matters remote from commerce among the states, as that it interferes with the paramount individual rights secured by the 5th Amendment. The section is, in substance, a very limited interference with freedom of contract, no more. It does not require the carriers to employ anyone. It does not forbid them to refuse to employ anyone, for any reason they deem good, even where the notion of a choice of persons is a fiction and wholesale employment is necessary upon general principles that it might be proper to control. The section simply prohibits the more powerful party to exact certain undertakings, or to threaten dismissal or unjustly discriminate on certain grounds against those already employed. I hardly can suppose that the grounds on which a contract lawfully may be made to end are less open to regulation than other terms. So I turn to the general question whether the employment can be regulated at all. I confess that I think that the right to make contracts at will that has been derived from the work 'liberty' in the Amendments has been stretched to its extreme by the decisions; but they agree that sometimes the right may be restrained. Where there is, or generally is believed to be, an important ground of public policy for restraint, the Constitution does not forbid it,

whether this court agrees or disagrees with the policy pursued. It cannot be doubted that to prevent strikes, and, so far as possible, to foster its scheme of arbitration, might be deemed by Congress an important point of policy, and I think it impossible to say that Congress might not reasonably think that the provision in question would help a good deal to carry its policy along. But suppose the only effect really were to tend to bring about the complete unionizing of such railroad laborers as Congress can deal with, I think that object alone would justify the act. I quite agree that the question what and how much good labor unions do, is one on which intelligent people may differ; I think that laboring men sometimes attribute to them advantages, as [208 U.S. 161, 192] many attribute to combinations of capital disadvantages, that really are due to economic conditions of a far wider and deeper kind; but I could not pronounce it unwarranted if Congress should decide that to foster a strong union was for the best interest, not only of the men, but of the railroads and the country at large.

§ 64. Ordinary income defined

How Current is This?

For purposes of this subtitle, the term "ordinary income" includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as "ordinary income" shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (b).

Search this title:

Search Title 26

Notes
Updates
Parallel regulations (CFR)
Your comments

Prev | Next

Sec. 64. - Ordinary income defined

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§ 1001. Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164 (d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164 (d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment sales

Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of

that portion of any installment payment representing gain or profit in the year in which such payment is received.

(e) Certain term interests

(1) In general

In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) Term interest in property defined

For purposes of paragraph (1), the term "term interest in property" means—

(A) a life interest in property,

(B) an interest in property for a term of years, or

(C) an income interest in a trust.

(3) Exception

Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

Prev | Next

§ 1011. Adjusted basis for determining gain or loss

How Current is This?

(a) General rule

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

(b) Bargain sale to a charitable organization

If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

Search this title:

Search Title 26

Notes
Updates
Parallel regulations (CFR)
Your comments

§ 1012. Basis of property—cost

How Current is This?

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

Search this title:

Search Title 26

Notes
Updates
Parallel regulations (CFR)
Your comments

Prev | Next

Sec. 1001. - Determination of amount of and recognition of gain or loss

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The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized -

(1)

there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2)

there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

(d) Installment sales

Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

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(1) In general

In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

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For purposes of paragraph (1), the term ''term interest in property'' means -

(A)

a life interest in property,

(B)

an interest in property for a term of years, or

(C)

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(3) Exception

Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons

Sec. 1011. - Adjusted basis for determining gain or loss

(a) General rule

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

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If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property

Sec. 1012. Basis of property - cost

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer

§ 1016. Adjustments to basis

(a) General rule

Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under the straight line method. Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020

(as in effect before the date of the enactment of the Tax Reform Act of 1976). Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913,

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

(C) since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply, and

(D) since February 28, 1913, during which such property was held by a person subject to tax under part II [1] of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) in the case of any bond (as defined in section 171 (d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171 (a)(2), and in the case of any other bond (as defined in section 171 (d)) to the extent of the deductions allowable pursuant to section 171 (a)(1) (or the amount applied to reduce interest payments under section 171 (e)(2)) with respect thereto;

(6) in the case of any municipal bond (as defined in section 75 (b)), to the extent provided in section 75 (a)(2);

(7) in the case of a residence the acquisition of which resulted, under section 1034 (as in effect on the day before the date of the enactment of the Taxpayer Relief Act of 1997), in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034 (e) (as so in effect);

(8) in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) for amounts allowed as deductions as deferred expenses under section 616 (b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this

subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

[(10) Repealed. Pub. L. 94–455, title XIX, § 1901(b)(21)(G), Oct. 4, 1976, 90 Stat. 1798]

(11) for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12) to the extent provided in section 28(h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

[(13) Repealed. Pub. L. 108–357, title IV, § 413(c)(19), Oct. 22, 2004, 118 Stat. 1509]

(14) for amounts allowed as deductions as deferred expenses under section 174 (b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) for deductions to the extent disallowed under section 272 (relating to disposal of coal or domestic iron ore), notwithstanding the provisions of any other paragraph of this subsection;

(16) in the case of any evidence of indebtedness referred to in section 811 (b) (relating to amortization of premium and accrual of discount in the case of life insurance companies), to the extent of the adjustments required under section 811 (b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;

(17) to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;

(18) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock;

(19) to the extent provided in section 50 (c), in the case of expenditures with respect to which a credit has been allowed under section 38;

(20) for amounts allowed as deductions under section 59 (e) (relating to optional 10-year writeoff of certain tax preferences);

(21) to the extent provided in section 1059 (relating to reduction in basis for extraordinary dividends);

(22) in the case of qualified replacement property the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale or exchange of any property, to the extent provided in section 1042 (d),[2]

(23) in the case of property the acquisition of which resulted under section 1043, 1044, 1045, or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, to the extent provided in section 1043 (c), 1044 (d), 1045 (b)(4), or 1397B (b)(4), as the case may be,[2]

(24) to the extent provided in section 179A (e)(6)(A),[2]

(25) to the extent provided in section 30 (d)(1),[2]

(26) to the extent provided in sections 23 (g) and 137 (e),[2](27) in the

case of a residence with respect to which a credit was allowed under section 1400C, to the extent provided in section 1400C (h),[2]

(28) in the case of a facility with respect to which a credit was allowed under section 45F, to the extent provided in section 45F (f)(1),[2]

(29) in the case of railroad track with respect to which a credit was allowed under section 45G, to the extent provided in section 45G (e)(3), [2]

(30) to the extent provided in section 179B (c),[2] and

(31) in the case of a facility with respect to which a credit was allowed under section 45H, to the extent provided in section 45H (d).

(b) Substituted basis

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in subsection (a) shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

(c) Increase in basis of property on which additional estate tax is imposed

(1) Tax imposed with respect to entire interest

If an additional estate tax is imposed under section 2032A (c)(1) with respect to any interest in property and the qualified heir makes an election under this subsection with respect to the imposition of such tax, the adjusted basis of such interest shall be increased by an amount equal to the excess of—

(A) the fair market value of such interest on the date of the decedent's death (or the alternate valuation date under section 2032, if the executor of the decedent's estate elected the application of such section), over

(B) the value of such interest determined under section 2032A (a).

(2) Partial dispositions

(A) In general

In the case of any partial disposition for which an election under this subsection is made, the increase in basis under paragraph (1) shall be an amount—

(i) which bears the same ratio to the increase which would be determined under paragraph (1) (without regard to this paragraph) with respect to the entire interest, as

(ii) the amount of the tax imposed under section 2032A (c)(1) with respect to such disposition bears to the adjusted tax difference attributable to the entire interest (as determined under section 2032A (c)(2)(B)).

(B) Partial disposition

For purposes of subparagraph (A), the term "partial disposition" means any disposition or cessation to which subsection (c)(2)(D), (h)(1)(B), or (i)(1)(B) of section 2032A applies.

(3) Time adjustment made

Any increase in basis under this subsection shall be deemed to have occurred immediately before the disposition or cessation resulting in the imposition of the tax under section 2032A (c)(1).

(4) Special rule in the case of substituted property

If the tax under section 2032A (c)(1) is imposed with respect to qualified replacement property (as defined in section 2032A (h)(3)(B)) or qualified exchange property (as defined in section 2032A (i)(3)), the increase in basis under paragraph (1) shall be made by reference to the property involuntarily converted or exchanged (as the case may be).

(5) Election

(A) In general

An election under this subsection shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Such an election, once made, shall be irrevocable.

(B) Interest on recaptured amount

If an election is made under this subsection with respect to any additional estate tax imposed under section 2032A (c)(1), for purposes of section 6601 (relating to interest on underpayments), the last date prescribed for payment of such tax shall be deemed to be the last date prescribed for payment of the tax imposed by section 2001 with respect to the estate of the decedent (as determined for purposes of section 6601).

(d) Reduction in basis of automobile on which gas guzzler tax was imposed

If—

(1) the taxpayer acquires any automobile with respect to which a tax was imposed by section 4064, and

(2) the use of such automobile by the taxpayer begins not more than 1 year after the date of the first sale for ultimate use of such automobile,

the basis of such automobile shall be reduced by the amount of the tax imposed by section 4064 with respect to such automobile. In the case of importation, if the date of entry or withdrawal from warehouse for consumption is later than the date of the first sale for ultimate use, such later date shall be substituted for the date of such first sale in the preceding sentence.

(e) Cross reference

For treatment of separate mineral interests as one property, see section 614.

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[1] See References in Text note below.

[2] So in original. The comma probably should be a semicolon.

Prev | Next

Willow Terrace Dev. Co. v. CIR, 345 F.2d 933 (5th Cir. 1965)

United States Court of Appeals Fifth Circuit.

WILLOW TERRACE DEVELOPMENT CO., Inc. and Post Oak Manor Building Co., Inc.,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

WILLOW TERRACE DEVELOPMENT CO., Inc. and Post Oak Manor Building Co., Inc.,

Respondents.

No. 21241.

June 1, 1965.

Rehearing Denied July 1, 1965.

Proceeding on petition of taxpayers to review a decision of the Tax Court of the United States, 40 T.C. 689. The Court of Appeals, Griffin B. Bell, Circuit Judge, held that taxpayers were required to include in their gross income full amount of trade-in allowances given to new house purchasers on their old houses, but taxpayer was allowed to add to costs of house and lot the cost of construction of water and sewage plant.

Affirmed on petition and cross petition.

Before GEWIN and BELL, Circuit Judges, and McRAE, District Judge.

GRIFFIN B. BELL, Circuit Judge.

Taxpayers are the Willow Terrace Development Co., Inc., and its wholly-owned subsidiary, Post Oak Manor Building Co., Inc. Both corporation engaged in developing real estate subdivisions in the Houston area, and filed consolidated corporate income tax returns for the tax years here involved, 1955-1958. They petition to review a decision of the Tax Court requiring the Building Company to include in gross income the full amount of 'trade-in-allowances' given to purchasers of new homes in return for equities in their old homes. The Commissioner cross-petitions from the Tax Court's decision allowing the Building Company to add the cost of constructing water and sewage facilities to the cost basis of the houses it built and sold. The opinion

of the Tax Court is reported at 40 T.C., 689. We affirm on both questions.

I. The Taxpayers' Appeal

Building Company built and sold new houses in the Post Oak Manor Subdivision in Harris County, Texas. In making sales of new houses, the building company often accepted the purchaser's interest or equity in his old house as part of the sales price for the new house in Post Oak Manor. The credit received by the purchaser, or 'trade-in allowance,' was treated as part of the down payment on the new house. The trade-in houses all had outstanding mortgages on them, and Building Company acquired them subject to the prior encumbrances. During the tax years here involved, Building Company made trade-in allowances on the equities in 151 houses in the total amount of $348,609.73. [FN1]

Rather than taking title to the trade-in houses directly, Building Company had the new house purchasers deed them to Terwil Corporation, a corporation owned in the same proportions by the same three men who owned Development Company which in turn owned Building Company. [FN2] Terwil attempted to resell the houses as soon as possible to avoid making mortgage payments, and all 151 were sold under contracts for a deed, with a small down payment, usually $200, and with the balance of the purchase price to be paid after the existing mortgage was satisfied. Interest on the contract price was to be paid in the interim. The total face amount of the 151 contracts was approximately $392,600, but when sales expenses were deducted from the initial payments totaling $34,200, the net amount of cash received was only $9,345.13. The balance due on the contracts was $358,600. There was no established market in the Houston area for the contracts received by Terwil Corporation for the trade-in houses.

The Commissioner determined that the entire amount of the trade-in allowances ($348,609.73) should be included in Building Company's gross income as part of the amount realized from the sale of new houses under § 1001(a), (b) of the Internal Revenue Code of 1954. That section provides that the 'amount realized from the sale * * * of property shall be the sum of any money received plus the fair market value of the property (other than money) received.' In the Tax Court, Building Company contended that the fair market value of the trade-in houses was not equal to the trade-in allowances, but was zero, or in any event, not more than from $8,000 to $12,000. The Tax Court held that Building Company failed to sustain its burden of showing that the fair market value of the trade-in houses was less than $348,609.73. We agree.

The standard for determining fair market value under 1001 is well established. It is the price at which property will change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts. French Dry Cleaning Co. v. Commissioner of Internal Revenue, 5 Cir., 1934, 72 F.2d 167. The Tax Court applied this standard. Stiles v. Commissioner of Internal Revenue, 5 Cir., 1934, 69 F.2d 951, relied on by taxpayers for their contention that the proper standard is the amount presently realizable in cash, is not to the contrary. Indeed, the court in the French Dry Cleaning Co. case so stated.

Given that the Tax Court applied the proper legal standard in determining fair market value, there was ample evidence to support its conclusion that the fair market value of the equities in the trade-in houses was at least equal to $348,609.73, the amount of the trade-in allowances. One factor considered by the Tax Court was what they were actually sold for in the open market, $392,600. The receipt of only slightly more than $9,000 net in cash after sales expenses does not alter the fact that the price at which Terwil sold the houses were substantially above the trade-in allowances. Moreover, and this is the long and short of the matter, the Commissioner introduced the testimony of two real estate appraisers which established a value for the trade-

in houses in excess of the trade-in allowances. Taxpayers' appraisers testified that the value of the houses was only $12,000, and there was other evidence to support the taxpayer' contention. However, the testimony of the Commissioner's witnesses was adequate, if credited as it was by the Tax Court, to carry the day for the Commissioner, and the finding by the Tax Court was in no event clearly erroneous. See Greer v. Commissioner of Internal Revenue, 5 Cir., 1964, 334 F.2d 20.

Taxpayers argue alternatively that even if the trade-in houses were worth the trade-in allowances, Building Company sold the houses to Terwil Corporation at a corresponding loss. In this regard, the Tax Court was correct in holding that there was no sale by Building Company to Terwil. Form must give way to substance in the tax law. Commissioner of Internal Revenue v. Court Holding Co., 1945, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981; Hindes v. United States, 5 Cir., 1964, 326 F.2d 150. [FN3]

It follows that the decision of the Tax Court requiring Building Company to include the full amount of the trade-in allowances in gross income must be and it is affirmed.

II. The Commissioner's Appeal

Building Company constructed all houses in Post Oak Manor Subdivision in accordance with Federal Housing Administration specifications and requirements in order to secure FHA or Veteran's Administration loan insurance guarantees on the mortgages to be utilized in the purchase of the new business. As a condition to issuing loan commitments on the subdivision, the FHA required that a satisfactory water system and sewerage disposal system be made available to the new houses. Building Company first attempted to secure these facilities from the City of Houston. Post Oak Manor was at that time beyond the city limits, and Houston declined to construct the facilities. After determining that it would be more economical to construct and operate its own systems rather than obtain them from a neighboring subdivider, Building Company constructed a water plant, sewerage disposal plant, and the necessary connecting systems. The total cost of these facilities to Building Company was $157,187.49.

By an instrument dated July 30, 1954, Building Company transferred the water and sewerage facilities to Post Oak Manor Water Company, Inc., a separate corporation owned in identical proportions by the same three men who owned Development Company and Building Company. The only consideration furnished by the Water Company was its agreement to operate the systems. The transfer agreement set the rates which Water Company would charge, and provided that the rates could be increased only if they proved insufficient to cover operating costs, provide sufficient reserves for replacement, obsolescence and depreciation, and a reasonable rate of return on the basis of capital investment.

Pursuant to FHA requirements, Water Company executed a trust deed transferring title to the facilities to an approved trustee for the benefit of the property owners. Water Company retained the active control and management of the systems, but the trust deed provided that if the Water Company abandoned the plant, changed the rate structure materially, or failed to provide satisfactory service, the trustee could take over the operation of the system for the benefit of the property owners.

Water Company carried the facilities on its books at a zero basis and no depreciation was ever claimed on them. The president of the company received no salary. Without allowance for depreciation, the operations of the company from 1955 through 1959 produced net income for the five year period of $12,934.02. [FN4] Assuming a five per cent replacement factor per year on cost, the operation resulted in a net loss of $17,702.80. [FN5]

By an ordinance enacted on December 31, 1956, the city of Houston annexed an area which included the Post Oak Manor Subdivision. Action by the city to annex this area had been begun by at least the preceding February. By ordinance of May 1, 1957, the city prohibited private water companies in the annexed area from increasing their rates until future rate hearings. Water Company sought permission to increase its rates but was refused. Negotiations for the sale of the facilities to the city were begun, and in September, 1959, the city of Houston purchased all of Water Company's water and sewerage facilities for $221,200. There were about 60 private water and sewerage systems in the area annexed in December, 1956, but by November 1962, the city had acquired only 40 of them. From 1950 to 1955, the city acquired 47 private systems that were located in an area annexed to the city in 1950.

Building Company sought to deduct the full $157,000 cost of the water and sewer systems as part of the cost basis of the lots it had developed. This was accomplished by allocating a pro rata portion of the $157,000 to the cost of each of the 432 lots in the subdivision. Under §§ 1012 and 1016 of the Internal Revenue Code, the proper basis for the lots is 'cost' plus 'adjustment * * * for expenditures * * * properly chargeable to capital account.' The Commissioner disallowed the deductions in full, taking the position that the cost of the water and sewerage systems was not part of the cost of the lots, but was an independent investment in separate valuable property, cost of which should be recovered through capitalization or subsequent sale. The Tax Court, relying on its prior decision in Estate of Collins v. Commissioner of Internal Revenue, 1958, 31 T.C. 238, sided with the taxpayers, and the Commissioner appeals.

The Commissioner's position is that the facilities may be allocated to the cost of the lots only if they are constructed in order to sell the lots and are permanently and irrevocably dedicated to the lot owners so that the cost of the facilities is recoverable in no other manner. Thus, streets, sidewalks, public parks and recreation areas in which the developer retains no interest are properly considered part of the cost of the lots sold. See Country Club Estates, Inc. v. Commissioner of Internal Revenue, 22 T.C. 1283 (1954). However, the Commissioner contends that the water and sewerage systems here involved were a separate investment in valuable and potentially income producing property by the developer, which property was retained by the developer rather than dedicated to the homeowners. The cost of such an independent investment, according to the Commission, should be recovered through depreciation of the facilities or subsequent sale. Here the taxpayer did in fact recover the cost by selling the facilities to the City of Houston.

Estate of Collins v. Commissioner, supra, involved a sewerage disposal system. There the Tax Court stated the rule as follows:

> '* * * if a person engaged in the business of exploiting a real estate subdivision constructs a facility thereon for the basic purpose of inducing people to buy lots therein, the cost of such construction is properly a part of the cost basis of the lots, even though the subdivider retains tenuous rights without practical value to the facility constructed (such as a contingent reversion), but if the subdivider retains 'full ownership and control' of the facility and does 'not part with the property * * * for the benefit of the subdivision lots,' then the cost of such facility is not properly a part of the cost basis for the lots.'

The opinions of the Tax Court in Collins and in this case are buttressed by the recent decision of the Fourth Circuit in Commissioner of Internal Revenue v. Offutt, 4 Cir., 1964, 336 F.2d 483. Taxpayer in that case was allowed to deduct the cost of water and sewerage systems on facts very similar to those presented here. We agree with the Tax Court and with the Fourth Circuit.

The problem presented by these cases is whether deduction or capitalization of such costs will more accurately reflect the economic realities of the situation from the standpoint of the subdivider. We cannot accept the rule advocated by the Commissioner, which in effect allows deduction only when the costs can be recovered in no other manner. Some relevant factors to be considered in determining the proper tax treatment of the costs of such facilities are whether they were essential to the sale of the lots or houses, whether the purpose or intent of the subdivider in constructing them was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses, whether and the extent to which the facilities are dedicated to the homeowners, what rights and of what value are retained by the subdivider, and the likelihood of recovery of the costs through subsequent sale. These factors were considered in Collins, and the holding centered on the basic purpose test as modified by ownership. The Tax Court said:

> '* * * We have concluded that petitioners constructed the sewerage system not only for the basic purpose but for the sole purpose of inducing and making possible the sale of lots * * *, that they did not retain full ownership and control of the sewerage system, and that they parted with material property rights therein for the benefit of the subdivision lots.'

In the present case the facts meet this test and support the conclusion of the Tax Court. The basic purpose of Building Company in constructing the facilities was to sell lots and houses, not to invest in the water and sewerage business. It was essential that the lots in the subdivision be supplied with water and sewerage, both in order to sell the lots and in order to secure FHA financing. Building Company constructed the facilities itself only after the City of Houston refused and after it was determined that to secure them from a neighboring subdivider would be more expensive.

The water and sewerage systems were, under the FHA trust deed, dedicated to the benefit of the lot owners. Legal title was held by the trustee for their benefit. Abandonment, impairment of service or any material increase in rates would give the trustee the right to take over the facilities. Water Company retained only the right and duty to operate the systems. There is no indication that the developers of Post Oak Manor anticipated any independent profit from the operations of Water Company, and, allowing for replacement costs, no profit was in fact made. At the time of the trust deed, the assets in the hands of Water Company had little if any saleable value. Sale to the City of Houston became possible only after the Post Oak Manor area was annexed to the city. The possibility of future sale to the city must be considered remote at that time, depending as it did on the vagaries of future annexation.

In sum, construction of the water and sewerage systems was necessary, if not essential, to the sale of homes in Post Oak Manor, and the systems were in fact constructed for that purpose, as distinguished from the purpose of independent investment. The facilities were dedicated to the benefit of the homeowners under the FHA trust deed, the rights retained by Water Company having at that time little if any saleable value, and the possibility of recovering the costs through future sale to the city was remote. The conclusion of the Tax Court that the cost of these facilities were properly allocated to the cost of the houses sold by Building Company rested on these conclusions of fact which find support in the record. Its decision was correct, and it is thus affirmed.

Affirmed on the petition and cross-petition.

Footnotes:

FN1. The Tax Court stated:

'A typical transaction would be somewhat as follows: Building Co. would offer a new house in Post Oak Manor for sale for $16,000. Mortgage arrangements on this new house could be made for $13,000. A prospective purchaser had a house that cost him $10,000 but was subject to an encumbrance of $8,000. He could buy Building Co.'s $16,000 home by paying $1,000 cash, deeding his old home to Terwil (subject to the $8,000 encumbrance) for which Building Co. would give him a $2,000 trade-in allowance, and making arrangements for a $13,000 mortgage on the new home to pay the balance of the $16,000 purchase price.'

FN2. This method was followed to avoid showing any contingent liability of Building Company for the outstanding indebtedness against the trade-in houses on its statement, and to prevent it from becoming involved in foreclosures to the displeasure of the Federal Housing Administration.

FN3. Building Company followed the bookkeeping practice with respect to the trade-in allowances of debiting an account called trade-in allowances for the amounts allowed, and then writing off these amounts at the end of the year as worthless. On its tax returns for the years in question it reported the allowances as sales receipts but deducted the amount thereof as expense. In the Tax Court they contended simply that they had overstated their new house sales to the extent of the allowances since the equities in the trade-in houses were without value.

FN4. The figures for each of the five years are as follows:

Net Income:

1955 -- $ (216.45) loss

1959 -- 1,044.47

1957 -- 12,697.20

1956 -- (2,877.60) loss

1958 -- 2,286.40

FN5. The corresponding annual figures are:

Net Income:

1955 -- $(2,146.43) loss

1956 -- (8,371.29) loss

1957 -- 5,202.79

1958 -- (5,572.97) loss

1959 -- (6,814.90) loss

Bankers Trust Co. v. United States, 518 F.2d 1210 (Ct.Cl. 1975)

United States Court of Claims.

BANKERS TRUST COMPANY et al.

v.

The UNITED STATES.

No. 89--67.

July 11, 1975.

Taxpayer brought action against United States to recover corporate income taxes assessed and paid. Motions for summary judgment were denied, 459 F.2d 484, 198 Ct.Cl. 306, and the matter was remanded to a trial judge for development of the facts. After the remand, the Court of Claims, Davis, J., held that the date on which taxpayer's shareholders approved the transaction rather than the date on which taxpayer and another corporation entered into a settlement agreement was the proper valuation date of stock in taxpayer which taxpayer received as part of the settlement and that the mean of the high and low prices at which the stock was sold on an organized exchange on that date was the value of the stock for income tax purposes.

Petition dismissed.

Kashiwa, J., dissented and filed opinion.

Before COWEN, Chief Judge, and DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG and BENNETT, Judges.

OPINION

DAVIS, Judge.

This action to recover corporate income taxes assessed and paid was brought on behalf of the Mesabi Trust by its trustees, as successor to the Mesabi Iron Company. The taxes were assessed as a deficiency in the Mesabi Company's 1960 return, and all relevant events occurred prior to the July 18, 1961 change to trust status. The company rather than the trust and trustees will be referred to as 'Mesabi,' 'the taxpayer,' and 'plaintiff.'

The disputed tax, amounting to $3,016,132.64 plus interest, arises from a difference between plaintiff and the Internal Revenue Service as to the value of 163,570 shares of Mesabi stock received by the company during 1960 from the Reserve Mining Company. The parties' earlier motions for summary judgment were denied without prejudice and the case remanded for full development of the facts. 459 F.2d 484, 198 Ct.Cl. 306 (1972). A trial was held before Trial Judge Lloyd Fletcher who decided in favor of the Government. We now confirm that conclusion.

I

Facts

The events leading to the ultimate transfer of the stock, which are rather complex, are fully set out in the findings of fact made by Trial Judge Fletcher and which we adopt with minor modifications. Here we summarize only the most important steps. Mesabi Iron Company was incorporated in 1919 to mine iron ore in the Mesabi Iron Range in northern Minnesota. In consideration for the issuance of its stock, the company acquired fee ownership of a 5,700 acre tract and a leasehold interest in two other areas, one of 720 acres (Cloquet lease), and the other of 9,000 acres (Peters lease). Although Mesabi attempted to mine the leaseholds, the iron was a low grade ore called taconite and needed concentration in order to become commercially useful. Mesabi was unable to concentrate the ore on a profitable basis and suspended all mining operations in 1924.

By 1939, Mesabi was in debt by approximately $258,000 with few liquid assets. To pay its debts, but at the same time to retain the possibility of future profits from mining operations, Mesabi agreed with Reserve Mining Company, a newly formed corporation the stockholders of which were four iron and steel corporations, to lease to Reserve the lands which Mesabi owned and to assign to that firm the two leasehold interests. In return, Reserve took over Mesabi's debts and agreed, among other things, to pay Mesabi one-third of the net profits obtained from the lands, and to 'endeavor to procure the highest current price known for material of like value in use and for like quantities' in making sales and determining profits. The parties set up a two-man board of abitration to settle disputes, with a third arbitrator to be appointed if the first two disagreed.

Between 1942 and 1944, Reserve purchased through negotiation and on the open market, but with the help of Raymond B. Hindle, a stock broker who was also a director of Mesabi, 148,700 shares of Mesabi stock, or approximately 12% of the outstanding total. Starting in 1951, Reserve began to develop its Mesabi leaseholds, having devised a commercially feasible way of concentrating the taconite. This development required capital expenditures of approximately $178 million which was financed in part by Reserve's stockholders and in part by borrowing. By 1956, Reserve began producing taconite pellets, an extremely useful form of iron ore, the entire production of which was sold under a 1953 agreement to the two companies which by then had sole and equal interests in Reserve--Republic Steel Corporation and Armco Steel Corporation.

From 1953 on, Reserve issued annual reports to Mesabi in which the former stated its net profits for the year and calculated Mesabi's share. Mesabi refused to accept each of these reports, contending that the sale price of the taconite was too low in that it did not take into account the efficiencies obtained by using the uniform, concentrated pellet, that some charges by Reserve for such items as hauling the taconite on Reserve's private railroad from the mine near Babbit to the production facilities at Silver Bay were too high, and that various other charges, such as losses on in-town real estate sales is Silver Bay, should not have been assessed at all. In addition, Reserve wished to offset immediately Mesabi's part of pre-production losses against Mesabi's profit share, while Mesabi wanted to amortize these losses over a number of years.

The preproduction loss issue was settled in 1956 with an agreement to amortize the pre-1956 losses over a 13-year period, one-third falling on Mesabi and two- thirds on Reserve. The other questions were still outstanding before either a two- or a three-man board of arbitration in February 1960.

During the late 1950's the differences between Mesabi and Reserve came to a head in litigation. In 1957, several Mesabi shareholders filed a derivative action against Reserve and the then Mesabi board of directors, complaining about the failure of Mesabi to effectively prosecute its claims against Reserve. The complaint stated that Reserve was indebted to Mesabi for 1956 profits in the amount of $8,000,000. The Delaware court in which the suit was brought sequested Reserve's stock holdings in Mesabi. In 1958, a dissident group of stockholders won a proxy fight against the old Mesabi management (Reserve voting its shares for the losing side). New management informed Mesabi shareholders that the arbitration would not lead to an acceptable agreement with Reserve in a reasonable period of time, and that Mesabi would now attempt to settle the differences in court. Reserve then filed an action in a Minnesota state court (removed at Mesabi's request to federal district court) to force Mesabi to live up to its agreement to arbitrate. Mesabi countered with counterclaims against Reserve and its stockholders, Armco and Republic, for antitrust violations in the distribution and pricing of taconite and for conspiring to interfere with the lease agreements. Mesabi also brought an antitrust action on a similar basis against Armco and Republic in the federal district court in Delaware and another suit in a Delaware state court against Reserve and Raymond Hindle, alleging a diversion of corporate opportunity in Reserve's 1940's purchases of Mesabi stock and requesting return of the stock. The new management also took over the position of the plaintiff stockholders in the Delaware derivative action. None of these cases was settled or completed prior to February 1960.

The alleged dollar values of the suits, according to the complaints were:

(1) $8,000,000 lost profits for 1956 in the derivative suit

(2) $16,166,667 lost profits for 1956 and 1957 in the Minnesota counterclaim

(3 $12,500,000 trebled ($37,500,000) for antitrust violations in the Minnesota counterclaim

(4) $22,500,000 trebled ($67,500,000) for antitrust violations in the Delaware federal suit

In addition, the Delaware state suit requested the return of 148,700 shares of Mesabi stock,[FN1] and Mesabi continued to pursue lost profit claims for 1958 and 1959 out of court. While the amounts listed above obviously overlap in some respects and are undoubtedly exaggerated, they do provide some idea of the magnitude of the claims Mesabi had outstanding against Reserve and its shareholders as of February 1960. [FN2]

By January 1960, the three-man board of arbitration had completed hearings on all questions except that of the propriety of Reserve's pricing of taconite pellets in its sales to its owners, Armco and Republic. On January 21, 1960, the independent arbitrator ruled that Reserve should turn over to Mesabi its records dealing with the price of taconite pellets in sales to Republic and Armco. The hearings were adjourned until March 1960.

Possibly because of this new development, the arbitration proceedings were never reconvened. Rather, Reserve initiated talks aimed at settlement of all disputes. Reserve's goal seems to have been to end all past, present, and future controversies over net profits by putting Mesabi's payments on a royalty-per-ton basis, a proposal Reserve had made several times since 1950. Mesabi was similarly anxious to get out of litigation on net profits, but only at a royalty substantially higher than that offered previously. Mesabi management was

also very interested in acquiring Reserve's 12% of the outstanding Mesabi stock, in order to eliminate the threat that Reserve would vote its stock in its own interest rather than Mesabi's.

On February 18, 1960, the negotiators reached an agreement under which Mesabi would receive $400,000 and all of Reserve's stock in Mesabi (now 163,570 shares, see footnote 1, supra). Mesabi would drop all claims against Reserve, its shareholders, and Hindle, and the 1939 agreement would be modified to provide Mesabi with royalties of $1.00 per adjusted ton of taconite concentrate shipped. At Reserve's request, the agreement provided that it would not become effective until approved by a majority of Mesabi's outstanding shares but that the shares held by Reserve could not be voted nor counted toward the majority. The closing was to take place on the fifth business day following approval by Mesabi's shareholders.

On February 19, 1960, Reserve's directors and its two shareholders approved the agreement. Mesabi's directors met the same day and passed a series of approving resolutions. The only significant difference between the agreement and the resolutions was that while the former indicated that the stock and cash would both be exchanged for the pre-1960 profits claims and those claims only (not for the antitrust claims), the resolutions provided that the cash would be tied to the claims relating to pre-production losses, the profits claim, and the lease modification, that all suits against Reserve would be dismissed by Mesabi with prejudice, and that Mesabi would receive Reserve's shares. The minutes of that meeting, and testimony taken at trial, indicate that Mesabi's directors were concerned whether the agreement was a fair exchange and also about its tax consequences, and the company's counsel, Mr. Lester Tanner, advised them on these matters.

While the minutes do not so show, Mr. Tanner testified that he had advised the board that the stock and cash together, using the closing price of the stock on the American Stock Exchange on February 18,--40 3/8, were worth approximately $7,000,000 and that this amount was about all Mesabi could expect to obtain from its pending claims. Mr. Tanner also advised, according to this trial testimony, that Mesabi's tax liability from the settlement would be a maximum of $7,000,000 of ordinary income, but that it was possible that the exchange could be viewed as a tax-free redemption or an exchange of capital assets.[FN3]

On February 20, Mesabi issued a press release and shareholder's letter stating that a settlement had been reached, subject to shareholder approval, and briefly outlining the details of the agreement. The release and letter, although not the agreement itself, also stated that the shares received would not be reissued. The formal settlement agreement, which tracked the draft agreement rather than the resolutions and was dated February 19, 1960, was signed by Mesabi's president on February 28, and by Reserve's on March 2. Between February 18 and March 2, the closing price of Mesabi stock on the American Stock Exchange rose from 40 3/8 to 60 7/8. On March 21, 1960, Mesabi sent its stockholders a proxy statement (dated March 18) for the April 22 shareholder's meeting at which there would be a vote on the settlement agreement. The proxy statement did not attempt to put any value on the shares to be received from Reserve. It also did not indicate that the stock was to be received only in exchange for the royalty claims. On March 22 and 23, it was reported in the press that Mesabi was considering changing from corporate to trust form to avoid double taxation of its profits if the settlement agreement were approved. On April 7, Reserve announced its intention to expand production, which would, of course, increase Mesabi's royalties.

During this entire period, various brokerage houses were advising customers to buy Mesabi stock as a good income investment and also for possible capital gain. Presumably because of the settlement and related activities, trading in Mesabi stock increased substantially in volume from February 18 on. For example, 24,600 shares were traded in January, 145,100 in February, and 172,700 in March. In addition, the price began a lengthy and substantial climb from 40 3/8 on February 18, 1960 to over 90 by the end of 1960. On

April 21, the day before the Mesabi shareholders' meeting, the stock closed at 82 3/4, and the mean sales price on April 22 was 78 1/4.

At the April 22 shareholders' meeting, the agreement was approved by a vote of 1,016,049 shares to 970 shares, far in excess of the 661,898 shares needed to ratify. Approximately 87% of the shares eligible to vote were voted. By April 27, when the closing took place, all of Mesabi's litigation with Reserve, Republic and Armco had been terminated. Mesabi received Reserve's shares, the $400,000 provided by the settlement agreement, and $1,464,960.05 as a royalty payment for the first quarter of 1960. The shares were received free and clear of all claims, liens, or encumbrances, since the sequestration orders covering them had been lifted at Mesabi's request on April 25. The mean price for which Mesabi stock was selling on the American Stock Exchange on April 27 was 73 1/4.

In its 1960 income tax return, plaintiff acknowledged that it had received income through the settlement agreement, declaring the shares to have been worth $5,908,966.25--163,570 shares at $40.375 each (the February 18, 1960 closing price on the American Stock Exchange) less a 'blockage' discount of $4.25 per share. The Internal Revenue Service, on the other hand, took the position that the proper value of the stock was its value on April 22, 1960 (when the shareholders approved the settlement agreement), that that value is best evidenced by the mean trading price on the American Stock Exchange that day, i.e., $78.25, and that plaintiff had not shown itself entitled to any blockage discount. Defendant therefore priced the stock at $12,799,352.50. The disputed tax is a result of this difference in valuation, with credits for increased state royalty taxes and for increased depletion deductions if the higher figure is taken into account.

The controversy in this court centers on whether (1) the value of the stock for tax purposes was its worth as of February 18, 1960, the date on which negotiators for Mesabi and Reserve reached their agreement, or April 22, 1960, the day on which the Mesabi shareholders gave their approval; and (2) if the April 22 date is chosen, the value of the stock on that date. Plaintiff contends that the value as of February 18, 1960 is the proper figure but that even if April 22 is the crucial date, the correct April 22 value of the block of shares was no more than its February 18 value.[FN4]

II

Valuation Date

Plaintiff insists that this is not an 'accounting' case, since there is no issue as to when the value of the shares was to be taken into income; Mesabi was on the accrual basis and taxpayer agrees that the taking-into-income date was April 22, 1960, when the Mesabi-Reserve agreement became final and binding through the vote of Mesabi's stockholders. But, says plaintiff, the valuation date need not be the same as the taking-into-income date; in this instance it should be February 18, 1960, when the parties made their bargain and (it is said) fixed a firm value for the shares to be transferred.

Our difficulty with this approach is that it runs counter to the basic principle that under the federal income tax system items are taken into income at their then current value. The Code's provision for different accounting methods, and related regulations, do not directly tell us this but they do so by implication, and this has been the consistent course of judicial and administrative treatment under the income tax. See Treas.Reg. ss 1.61-- 2 (d) (4), 1.451--1(a), 1.61--2(d)(2)(i). It is this proposition which, for example, creates the need to undertake the difficult task of determining the present value of future interests. See Treas.Reg. § 1.1001--1(a); Rev.Rul. 58--402, 1958--2 C.B. 15; Grill v. United States, 303 F.2d 922, 925--26, 157 Ct.Cl. 804, 809--11 (1962).

Compare Burnet v. Logan, 283 U.S. 404, 51 S.Ct. 550, 75 L.Ed. 1143 (1931) (rights to future receipts presently incapable of valuation need not be included in income until received). When income is received, be it on the day the right to receive becomes fixed, as with an accrual basis taxpayer, or when beneficial ownership commences for a cash basis taxpayer, the amount of income received becomes set at its then value. See Fordyce v. Helvering, 64 U.S.App.D.C. 181, 76 F.2d 431, 434--35 (1935); C. M. Hall Lamp Co. v. United States, 201 F.2d 465, 468 (C.A. 6, 1953); Hoffer v. Comm'r, 24 B.T.A. 22, 27 (1931). Parties cannot arbitrarily decide that they are dealing, for instance, in deflated 1933 dollars when cash is received. While an exchange of property is more complex in that the current value of the item received may not be self-evident, the same principle applies.

Plaintiff cites two recent cases which it claims support its point that an item, particularly stock, need not be taken into income at its value on the date on which it is includable in income. White Farm Equipment Co. v. Commissioner of Internal Revenue, 61 T.C. 189 (1973), rev'd sub nom., Amerada Hess Corp. v. Comm'r, 517 F.2d 75 (C.A. 3, 1975),[FN5] while relevant on the subject of valuation, does not at all sustain taxpayer on the date-of-valuation issue. In White Farm, the court clearly viewed the proper valuation date as October 31, 1960, the day on which shareholders of both companies approved the agreement, and felt called upon to determine the proper value of the stock received as of that date. 61 T.C. at 214--15; 517 F.2d at 83 n. 29. Whatever the correctness of the court's determination of the value as of October 31, 1960, that was plainly chosen as the valuation date.

The other case is Herbert J. Investment Corp. v. United States, 360 F.Supp. 825 (E.D.Wis.1973), aff'd per curiam, 500 F.2d 44 (C.A. 7, 1974), in which plaintiff trucking company sold all its assets to a second company, CW Transport, Inc., in return for cash and stock in CW. The agreement, which was subject to approval by the I.C.C., provided that CW would take control of the assets and the assets would be appraised to set a firm sales price as soon as possible after temporary approval of the I.C.C. was received, but that title would not actually pass in either direction until the I.C.C. granted permanent authority. Following I.C.C. temporary approval on March 26, 1968, CW, on April 1, took over all plaintiff's assets and customers, and replaced all officers and all but one director. By agreement, all profits and losses of the business after April 1 were CW's, and plaintiff received interest on the purchase price--the value of the assets as of April 1--from that date until final settlement. I.C.C. permanent approval followed, and the agreement was formally closed on August 30. The market price of CW stock had increased substantially between April 1 and August 30, and after plaintiff valued the shares as of the earlier date, the Service assessed a deficiency, claiming that the later time was proper for valuation. The District Court found that, while I.C.C. approval was not a mere formality, it was so likely that everyone--the stock market, the industry, and most important the parties--treated the transfer as completed on April 1. In those circumstances, the court found that equity compelled a finding that the shares had been effectively transferred on April 1, and the value on that date should control.

The critical difference between Herbert J. Investment and the present case is that in the former the parties did not wait for final ICC approval to close the transaction but effectively closed it as of April 1st and deemed it permanent as of that time. As the District Court pointed out (360 F.Supp. at 827-- 28), the 'consummation itself (after final ICC approval), however, was actually nothing more than formalization of the arrangement effected by the parties on April 1,' and the parties 'fully committed themselves to the impact of their agreement on April 1, 1968, and treated the possible failure of final approval as a real, but highly unlikely condition subsequent. * * * The time of transfer of dominion and control over assets which are the subject of a sale is a more important consideration than the time of ultimate payment or conveyance of formal title.'

Here, on the other hand, no effort was made to close in any way before the vote of the Mesabi stockholders on April 22, nor was it ever contemplated that the actual closing could or would precede that event. The

parties were very careful not to disturb the main bargaining counters each had--the lawsuits--until after shareholder approval. The agreement's provision that closing would be delayed for five days after approval was related to this decision. No stock or money changed hands before April 22. Reserve's plans for expansion, though announced between the signing of the agreement and the Mesabi stockholders' meeting, stated that expansion would be undertaken '(i)f the settlement is made as contemplated, * * *' (emphasis added). The shareholders' approval was treated throughout as a most significant condition precedent, not as a condition subsequent as in Herbert J. Investment. In short, while the present parties could have presented us with a case like that one, they have not.

We add that here stockholder approval, though probable, was surely not a mere formality. Mesabi stockholders had not been a docile group, as the 1958 proxy fight showed, and major blocks of shares were still in the hands of persons associated with old management. Furthermore, Mesabi had, on the record date for the vote, over 2700 individual and 250 institutional shareholders. Most of the shareholders had fewer than 100 shares, and no individual shareholder owned more than 37,154 shares directly. Since Mesabi had agreed to an absolute majority vote, non-voting shares were in effect voted against the agreement. While Mesabi's board of directors might have been convinced that those who voted would vote for the agreement, the failure, through disinterest or inadvertence, of small shareholders to vote could have prevented ratification and must be considered a risk to final approval of the agreement. In fact, the agreement received the vote of only 87% of the eligible shares, not the 99.9% plaintiff has claimed.

Plaintiff has argued that acceptance of the accrual date as the valuation date leaves the parties unable to determine in advance the tax consequences of a transaction in which actively traded stock is exchanged. The point fails to recognize that the participants could agree on a purchase price and provide that it would be paid in 'x' shares of stock at the market price on the final date of agreement plus or minus a cash balancer. There is no reason to believe that this formula was considered and rejected in this instance as infeasible. As the evidence and particularly the testimony of Mr. Jesse Climenko, plaintiff's counsel at the time, shows, Mesabi was not particularly interested in how many dollars it was receiving (beyond a certain minimal amount) but in ending Reserve's interest in Mesabi and in modifying the lease agreement. (Claimenko, Tr. at 109--110.) Plaintiff, while it had concern for the tax consequences, had other thoughts uppermost in its corporate mind in February 1960, and should not be heard now to complain that, if it had wanted to, it could not effectively have arranged the transaction so as to predetermine the tax consequences.

Nor is it an adequate answer to say that the Treasury would not be harmed by allowing the parties to fix the value of transferred property at a time prior to and lower than the date-of-taking-into-income since a decrease in one side's tax (as here)[FN6] would be counterbalanced by an equivalent increase in the tax owed by the other side. That is not always true even if the Service manages to keep both taxpayers before it at the same time; the theoretical increase in tax for the one party may be washed out, in actual fact, by its own special circumstances. And in any event it would be a considerable administrative burden on the Service to ensure that in all such instances it kept the cases of the two (or several) taxpayers always in tandem so as to be able to collect, on balance, a tax based on the property's value at the date-of-taking-into-income. The general rule is that while the parties may be normally bound by the value agreed upon between them, the Service is not so restricted. Commissioner v. Danielson, 378 F.2d 771, 774--75 (C.A. 3), cert. denied, 389 U.S. 858, 88 S.Ct. 94, 19 L.Ed.2d 123 (1967); see Eckstein v. United States, 452 F.2d 1036, 1042, 196 Ct.Cl. 644, 655 (1971).

III

Value as of April 22, 1960

Our decision that the stock received must be valued at its April 22, 1960 value does not decide what that value was. The starting place for discussions of value is of course the proposition that the 'fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts.' Jack Daniel Distillery v. United States, 379 F.2d 569, 574, 180 Ct.Cl. 308, 315--16 (1967). Where stock is freely traded in an open, organized market, stock exchange quotations for the valuation date generally provide the best evidence of value.[FN7] See Moore-McCormack Lines, Inc. v. Comm'r, 44 T.C. 745, 759 (1965); Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1252, 188 Ct.Cl. 302, 351--52 (1969); 10 J. Mertens, The Law of Federal Income Taxation ss 59.13 at 42--43, 59.14 at 47 (1970). However, extraordinary circumstances relating either to the state of the market or to the shares actually being valued can make market quotations unreliable indicators of true value. Taylor v. United States, 33 AFTR2d 74--1317, 1320 (E.D.N.C.1974). Several possible factors have been discussed in this regard and plaintiff has, at various points in the proceeding, suggested that some may be applicable.

A. Primarily, plaintiff says that the shares should be valued by the 'barter-equation method' in which the value of an item received in an arms- length transaction is taken as equal to the value of the item given up. Under this theory the value which intelligent, knowledgeable parties with adverse interests put on an item should be regarded as the fair market value of that item, given the circumstances of the trade, since there usually is no other trade available for comparison which is identical in all respects. While the thought has some appeal, in all the cases we have been able to find in which it was used, the objective market price suffered from some deficiency not present here. See, e.g., Moore-McCormack Lines, supra (market too 'thin' to absorb shares; shares carried 'a bundle of collateral rights'); Southern Natural Gas, supra (no recent sales of closely held stock). In the present instance, there is no comparable reason for rejecting the active trading price on the exchange on April 22; if plaintiff had chosen to reissue the shares at that time it would have gotten that price (as we shown infra).

We also find that plaintiff's position suffers from the fatal flaw that there was no clear agreement between the parties on the value of what was being exchanged. See KFOX Inc. v. United States, 510 F.2d 1365, 1370--71, 206 Ct.Cl. --- (1975); Bar L Ranch Inc. v. Phinney, 426 F.2d 995, 1001 (C.A. 5, 1970). Unlike Southern Natural Gas and Moore-McCormack, supra, no value for the stock or for the items (release of claims) given in return was stated in the agreement. Nor did the agreement on its face tie the value of the shares to the then stock exchange price. There is absolutely no evidence in the record about what Reserve though was the value of what it was receiving. There is no indication in the minutes of the February 19 Mesabi directors' meeting (although there is in Mr. Tanner's notes prepared for that meeting) that there was discussion of the $7,000,000 figure for the total value received. Similarly, the proxy statement is silent in this regard. And the validity of the $7,000,000 figure is certainly open to question in light of the fact that it includes only the pre-1960 royalty claims while, no matter how the agreement was in fact drafted, Mesabi was actually giving up its right to pursue its antitrust cases, and its claims for the premium value of the taconite pellets, claims which together exceeded $50,000,000. In addition, Mesabi received more than stock and money--it received the right to definite and certain royalty payments in a clearly determinable amount--a right which it had not had before and which was, in fact, a major objective of the bargain.

Even if plaintiff were to overcome this significant hurdle of lack of a clear agreement on value, the 'barterequation method' should not be used. As the Second Circuit noted in a similar case, that method

is a means which should be used only under certain limited conditions. The authority for it comes almost exclusively from cases involving valuation of property for which there is little or no market; * * * There are

obvious dangers in evaluating the consideration involved in one side of a barter by determining the worth of the consideration on the other side. In the first place, the two sides of the barter may, for various reasons, not be equal in value. Secondly, the barter-equation method is in the nature of a bootstrap operation since there is usually no logical reason to start with one side rather than the other. * * * Thirdly, the evidence on the value of one side of a barter may be no more reliable than that on the value of the other side.

Seas Shipping Co. v. Comm'r, 371 F.2d 528, 529--30 (C.A. 2), cert. denied, 387 U.S. 943, 87 S.Ct. 2076, 18 L.Ed.2d 1330 (1967). All the problems highlighted by that court are present here.

First, there is the distinct possibility that the two sides of the barter were not equal in monetary value. According to the testimony of Mr. Climenko, Mesabi was most interested in two things: getting rid of Reserve's power over Mesabi by eliminating Reserve's stock ownership, and revising the lease agreement to give Mesabi an easily determinable royalty. The number of shares which Mesabi wanted to receive from Reserve was clear--all of them. What value each share had was, while not irrelevant, relatively unimportant, as was the total value. As one commentator has noted, '(W)hen shares are repurchased by a corporation from a dissenting stockholder, perhaps to get rid of him at any price (, the) stockholder might have been paid far more than his stock was worth, part of the payment actually representing nuisance value.' Holzman, When actual sales may not establish fair market value for securities, 29 J.Tax 134, 135 (1968). Here, as there, the important objective was to separate the other side from the shares, not to get a price equivalent to the things given up by Mesabi.

Second, plaintiff has not supplied us with a good reason why we should value the stock by the claims rather than the other way around. This is not a situation where an independent appraisal of the value of the claims was available, so that doubts about the wisdom of using April 22 market quotations as the value of the stock could be resolved by reference to an independent estimate of the value of what Mesabi was giving up. And third, the value of what was exchanged for the stock here is, if anything, even more speculative than the value of the stock. In addition to the problem of determining exactly what was given up, plaintiff has produced testimony on the speculative nature of some of its claims, and has shown that even the value of the pre-1960 profit share claims is difficult to determine. There is, for example, no cogent evidence in the record of the exact value of the 1959 claim--all we know is that Reserve thought Mesabi entitled to $661,469, and that Mesabi thought 'maybe we would have gotten $1,500,000, somewhere in that area' (Tanner, Tr. at 51). In the major case on the subject, United States v. Davis, 370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962), the Court made no attempt to even try to determine directly the value of what the taxpayer had received (release of marital rights), but evaluated those rights by reference to the more easily ascertained value of the stock the plaintiff had given up. We think a similar solution is applicable here.

B. Restricted stock will frequently have a lower value than that traded on the exchange since it is by definition less marketable (see, e.g., Heiner v. Crosby, 24 F.2d 191, 193 (C.A. 3, 1928)), but there is no ground for reducing the value of the shares at issue simply because they were originally subject to the Delaware sequestration orders. The settlement agreement provided that the actions under which the shares were sequestered would be dismissed 'at or prior to closing' and the sequestration order in the Mesabi v. Reserve and Hindle case (the only order in evidence) provided that upon dismissal of the action the shares would be released from sequestration. Furthermore, that same order provided that, on Reserve's direction, the stock could at any time be sold upon provision of equal security. Presumably, this provision would include a sale to Mesabi. In any event, the shares received were released from sequestration on April 25 and were received free and clear. Since the likelihood of the shares being obtained by Mesabi in restricted status was, by the terms of the settlement agreement, extremely small, we conclude that no deduction in the market price should be made on this account.

C. A corollary of the point just discussed is plaintiff's claim that the shares should be valued at a price other than the April 22d market price because they were not to be resold. But taxpayer had not entered into any binding agreement with anyone, including Reserve, to that effect. The cases cited are distinguishable in that there the parties exchanging the shares had agreed that the stock would not be resold or could be resold only under restrictive conditions. See White Farm Equipment Co., supra, 61 T.C. at 201--02 (stock to be distributed to recipient's shareholders or sold in a public offering with no order for more than 10,000 shares filled); Seas Shipping Co. v. Comm'r, 24 CCH Tax Ct. Memo 1222, 1226 (1965), aff'd, 371 F.2d 528 (C.A. 2, 1967), cert. denied, 387 U.S. 943, 87 S.Ct. 2076, 18 L.Ed.2d 1330 (1967) (shares to be held for investment and not resold). Moreover, plaintiff's action in early 1961 of floating a stock issue almost as large as the number of shares received from Reserve suggests that the plan to retire the shares permanently was not, in fact, fully realized.

D. Another point is that the market prices either should be discarded completely or discounted because they are not reflective of the price at which the extremely large block of stock involved here would have sold, a phenomenon known as 'blockage.' See Treas. Reg. § 20.2031--2(e). We note first that plaintiff has not objected to the trial judge's refusal, by implication, to find it entitled to a blockage discount. Our own analysis leads us to the same conclusion. While a large block of shares dumped on the market at one moment will ordinarily depress the market price for a time, Seas Shipping Co. v. Comm'r, supra 371 F.2d at 530, the courts which have considered the blockage issue have concluded that the problem should be treated in terms of whether the market could have absorbed the shares within a reasonable period of time. Richardson v. Comm'r, 151 F.2d 102 (C.A. 2, 1945), cert. denied, 326 U.S. 796, 66 S.Ct. 490, 90 L.Ed. 485 (1946); White Farm Equipment Co., supra, 61 T.C. at 215. In those cases in which either a blockage discount has been allowed or the market price disregarded entirely because too large a block was involved, the number of shares being valued was very much greater than the total shares traded in a year. See, e.g., Amerada Hess Corp., supra, 517 F.2d at 89, 91 (665,000 shares being valued; 444,000 traded during entire year); Moore-McCormack Lines, Inc., supra, 44 T.C. at 760 (300,000 shares being valued; 166,000 traded during entire year). In the present case, the record shows that the number of shares to be valued is smaller than that traded during the single month of March 1960. In the absence of any evidence from plaintiff to the contrary, we conclude that with this type of active market the shares could have been absorbed fast enough for a blockage discount to be inapplicable, and that the number of shares involved is not so large as to make the market prices inherently suspect.[FN8]

E. Plaintiff's final argument is one initially broached from the bench at oral argument on the earlier cross-motions for partial summary judgment. It was suggested then that, on analogy to condemnation cases, if plaintiff could prove that the increase in the value of the shares was a result of the settlement agreement, the fair market value for tax purposes might be considered the 'preaction' value, the worth as of February 18. Further reflection, aided by the presentations of the parties, has convinced us that the analogy is inapposite.

The Supreme Court has stated that in determining the amount due the owner of condemned property under the just compensation clause, '(it) is not fair that the government be required to pay the enhanced price which its demand alone had created. That enhancement reflects elements of the value that was created by the urgency of its need for the article. It does not reflect what 'a willing buyer would pay in cash to a willing seller,' in a fair market. * * * (T)he enhanced value reflects speculation as to what the government can be compelled to pay. * * * That is a value which the government itself created and hence in fairness should not be required to pay (citations omitted).' United States v. Cors, 337 U.S. 325, 333--34, 69 S.Ct. 1086, 1091, 93 L.Ed. 1392 (1949); see United States v. Miller, 317 U.S. 369, 375, 63 S.Ct. 276, 87 L.Ed. 336 (1943).

This rule excluding such 'enhancement' has been limited, so far as we are aware, to condemnation cases, and there are several reasons why it should not be extended in plaintiff's favor. First of all, if the value of the shares was enhanced here because of the settlement agreement, that was due to the actions of both Mesabi (buyer) and Reserve (seller), and not that of the buyer alone; the increase was not attributable, as in the condemnation cases, to the buyer's special need for the property which itself pushed the price upwards. Second, it has not been proven what part of the increase was due to the settlement agreement and what part to Reserve's collateral but separate plan to increase production and to Mesabi's change-over from the corporate to the trust form. Third, Mesabi could, as we have discussed above, have resold the stock at its enhanced value and reaped the benefits of the enhancement. In a condemnation proceeding, on the other hand, the assumption is that, but for the condemnor's desire to acquire, the property could not have fetched the premium value claimed for it. If it were not for the 'enhancement-exclusion' rule, the public authority would have to pay an extra sum, attributable to its announced need, which it would be unlikely to recoup or obtain any value for. The principle is one of fairness to the condemnor and at the same time to the condemnee. Finally, we note that Mesabi was the recipient of the higher-value shares without being required to pay more than had been agreed on February 19, 1960, for those shares. This is the result the non-enhancement principle yields in the condemnation cases, and there is no need to tack on extra benefits to the buyer by taxing him at the lower value though he received and could take advantage of the higher.

Our conclusion, then, is that plaintiff has not produced any adequate reasons why we should disturb the defendant's determination that the traditional basis for valuation of widely-held stock should be used. We hold that the value of the stock Mesabi received was, on April 22, 1960, the mean of the high and low prices at which the stock was sold on the American Stock Exchange on that day, $78 1/4.

The taxpayer is not entitled to recover and the petition is dismissed.

KASHIWA, Judge (dissenting):

I respectfully dissent from the majority for the reasons hereinafter stated.

26 U.S.C. § 1001(b) (1970) provides, as pertinent herein, that the 'amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.' (Emphasis supplied.) Under this basic section, the present case turns out to be a simple stock valuation case. There is no dispute in this case as to when income was to be reported so we are not concerned with the date on which all the events had occurred which would require Mesabi to accrue the value of the stock as income.[FN1] Our sole concern is the 'market value' of the stock.

In Jack Daniel Distillery v. United States, 379 F.2d 569, 574, 180 Ct.Cl. 308, 315--316 (1967), we stated that:

* * * The legal definition of fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts. Wood v. United States, 29 F.Supp. 853, 89 Ct.Cl. 442 (1939). (Footnote omitted.)

This definition is identical to that in United States v. Cartwright, 411 U.S. 546, 551, 93 S.Ct. 1713, 36 L. Ed.2d 528 (1973). See, also, White Farm Equipment Co. v. Commissioner, 517 F.2d 75 (3rd Cir., May 13, 1975),[FN2] rev'g, 61 T.C. 189 (1973), where the same Cartwright decision of the Supreme Court is referred

to and the decision of the Third Circuit is based on this fundamental principle.

The majority properly finds in its opinion portion of the decision (as distinguished from the findings of fact) that plaintiff and Reserve entered into an agreement:

On February 18, 1960, the negotiators reached an agreement under which Mesabi would receive $400,000 and all of Reserve's stock in Mesabi (now 163,570 shares, see footnote 1, supra). Mesabi would drop all claims against Reserve, its shareholders, and Hindle, and the 1939 agreement would be modified to provide Mesabi with royalties of $1.00 per adjusted ton of taconite concentrate shipped. At Reserve's request, the agreement provided that it would not become effective until approved by a majority of Mesabi's outstanding shares but that the shares held by Reserve could not be voted nor counted toward the majority. The closing was to take place on the fifth business day following approval by Mesabi's shareholders.

It is important to note the majority also found specifically in its findings- of-fact portion of the decision that a price of $40 3/8 per share was 'considered by the taxpayers' board of directors at their February 19, 1960 meeting' (Findings 52) when they considered and approved the settlement (Findings 32, 35). The majority further found that at that meeting the board of directors was advised by counsel 'that $7,000,000 was the maximum amount that reasonably could be expected for (Mesabi's) pre-1960 claims' (Findings 35) and that in satisfaction of those claims Mesabi was receiving $400,000 cash plus Mesabi stock worth $6,600,000 being the 163,570 shares of Mesabi stock at $40 3/8 per share, thereby realizing what was essentially a complete victory with respect to its pre-1960 net profits claims (Findings 35). These findings are recited here because the majority after making these findings should not overlook the rest of the record in this case.

An examination of the entire record in this case shows that the evidence is clear, compelling, conclusive, and uncontradicted that the 163,570 Mesabi shares were valued on a $40 per share basis. There are 142 pages of uncontradicted testimony by witnesses Lester J. Tanner and Jesse Climenko in the record which clearly prove this. Furthermore, the fact that $40 was used as the per share value is supported not only by parol evidence but by documentary evidence received in evidence at the trial, plaintiff's Exhibit B. Added thereto, witness Lester J. Tanner explained in connection with Exhibit 58 the $7,000,000 settlement figure. Up until 1956 Reserve incurred operating losses which it claimed to be $18,421,844.23. Mesabi claimed they were $15,314,582.19. The losses had to be recovered from profits before Mesabi could get its one-third share. An agreement was made whereby the losses would be amortized over a 13-year period so that if every year there were profits over and above one-thirteenth of the pre-production losses, Mesabi would get royalties. An amortization of $15,314,582.19 at one-thirteenth a year for 1956, 1957, and 1958 would leave $11,780,447.85 in unamortized losses. Therefore, one-third would have to be deducted from the balance due Mesabi: $9,808,542.70--$3,926,815.95 = $5,881,726.75. To this, add the claim for 1959 of approximately $1,500,000, resulting in a total of $7,381,726.75. This conclusively shows that $7,000,000 was the settlement figure based on concrete figures.

In view of the clear record in this case above pointed out, it is difficult to depart from the conclusion that the parties intended the transaction to be $400,000 plus 163,570 shares at $40 3/8 for claims worth about $7,000,000. The arithmetic below cannot be denied:

163,570 shares at $40 3/8 = $6,604,138.75

Cash paid = 400,000.00

$7,004,138.75

This arithmetic is not a pure coincidence because $40 3/8 was the market price of Mesabi shares on February 19. Where the evidence is undisputed and the results are supported by plain arithmetic, there was only one conclusion the majority could have reached--the agreement and bargain of the parties necessarily included the value of $40 3/8 per share.

Under any written contract, consideration if not recited in the contract may be proven by parol evidence. Bernatschke v. United States, 364 F.2d 400, 404--405, 176 Ct.Cl. 1234, 1239--40 (1966); Paccon, Inc. v. United States, 399 F.2d 162, note 11, 185 Ct.Cl. 24, note 11 (1968). Although the value of the 163,570 Mesabi shares was not recited, it was proven by parol evidence. The trial judge allowed 147 pages of testimony to prove that the shares were valued at $40 per share, the February 19 value. Documentary evidence was also allowed to fully corroborate the parol proof. Such proof uncontradicted is equivalent to a full recital of the consideration in the contract.

In tax cases where parties to a contract agree to a price, courts will let the contract price stand. This is a rule of much significance because the Supreme Court in United States v. Davis, 370 U.S. 65, 82 S.Ct. 1190, 8 L. Ed.2d 335 (1962), used the above-mentioned rule to partially reverse a prior opinion of this court. Davis v. United States, 287 F.2d 168, 152 Ct.Cl. 805 (1961). The Court stated 370 U.S. at 72--73, 82 S.Ct. at 1194:

> It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 189, 130 Ct.Cl. 166, 172 (1954), that the values 'of the two properties exchanged in an arms-length transaction are either equal in fact or are presumed to be equal.' Accord, united States v. General Shoe Corp., 282 F.2d 9 (C.A.6th Cir. 1960); International Freighting Corp. v. Commissioner, 135 F.2d 310 (C.A.2d Cir. 1943). To be sure there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. Cf. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 67, 62 S.Ct. 925, 930, 86 L.Ed. 1266 (1942). (Emphasis supplied.)

The rule has since been followed by this court. See Davee v. United States, 444 F.2d 557, 195 Ct.Cl. 184 (1971); Republic Steel Corp. v. United States, 40 F.Supp. 1017, 94 Ct.Cl. 476 (1941); Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959). And more recently, this court stated in KFOX, Inc. v. United States, 510 F.2d 1365, at p. 1370 (Ct.Cl., 1975):

When two parties to the sale of assets explicitly allocate the aggregate purchase price to the various assets

being sold, the valuation they put on each asset will usually be accepted for tax purposes so long as the parties have opposing tax positions and have acted without collusion or fraud and the allocation is not so disproportionate as to be unreasonable. Davee v. United States, 444 F.2d 557, 195 Ct.Cl. 184 (1971); Republic Steel Corp. v. United States, 40 F.Supp. 1017, 94 Ct.Cl. 476 (1941); Annabelle Candy Co. v. Commissioner, 314 F.2d 1 (9th Cir. 1962); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959). To the extent, therefore, that the parties agreed to allocate and in fact did allocate the aggregate price over all of the assets we would be constrained to follow that allocation as the basis to be applied in depreciating those assets. * * * (Emphasis supplied.)

There is no finding of collusion or fraud by the majority. The exchange quotation of Mesabi shares was at $40 3/8 on February 19 so there is nothing disproportionate in using a $40 figure.

The majority's reason for departing from the $7,000,000 agreement is the following:

> * * * And the validity of the $7,000,000 figure is certainly open to question in light of the fact that it includes only the pre-1960 royalty claims while, no matter how the agreement was in fact drafted, Mesabi was actually giving up its right to pursue its antitrust cases, and its claims for the premium value of the taconite pellets, claims which together exceeded $50,000,000. In addition, Mesabi received more than stock and money--it received the right to definite and certain royalty payments in a clearly determinable amount--a right which it had not had before and which was, in fact, the major objective of the bargain.

The $7,000,000 figure is not open to question because it was agreed upon by the parties and since there is no fraud or collusion, it should not be disturbed. As for Mesabi's rights to receive royalty payments for the iron ore, the prior lease agreement provided for a percentage-of-profit type of payment. The new agreement provided for a fixed amount per ton. It was a mere substitution of one method of computation over another. The majority opinion sounds as if an entirely new source of income was provided. This was not so. The antitrust claims were valued at zero at the request and insistence of Reserve (Tr. 129--130). The parties so decided and we should not engage in the revaluation of antitrust claims, a task most difficult and extremely speculative.

The majority treats the shareholder approval in this case as a condition precedent. I quote:

> * * * The shareholders' approval was treated throughout as a most significant condition precedent, not as a condition subsequent as in Herbert J. Investment. In short, while the present parties could have presented us with a case like that one, they have not.

The majority evidently missed a material point in the transcript. Under the laws of the State of Delaware, where Mesabi was incorporated, it was not necessary to obtain shareholder approval of the February 19 settlement agreement. The Board of directors of Mesabi had the authority to enter into the agreement without shareholder approval (Tr. 71--72). The provision as to Mesabi shareholder approval was put in the settlement agreement only at the request of Reserve.

A careful reading of the agreement, therefore, shows that the parties entered into a binding agreement when they signed the agreement. But they were to be discharged of their assumed obligations if the shareholders' approval did not take place. I incorporate the material portions of the agreement to show that a condition

subsequent was intended.[FN3] The language of paragraph 9 of the agreement, which reads as follows:

> 9. The Closing shall be held on the fifth business day following the close of the meeting of Mesabi's stockholders approving and authorizing the matters covered by this agreement as hereinbefore provided at the office of Republic, Republic Building, Cleveland, Ohio, or at such other time and place as Mesabi and Reserve shall theretofore mutually agree. If the Closing is not held, this agreement shall become null and void and shall be without prejudice to Mesabi, Reserve, Armco and Republic, and their respective present and former officers, directors and stockholders.

clearly shows a present obligation to be discharged upon the nonoccurrence of the condition subsequent; to wit, disapproval by the shareholders.

Furthermore, as a part of the record in this case, Gilbert M. Haas, in Answer to Interrogatories,[FN4] filed December 30, 1970, stated as follows:

> Moreover, Reserve was not concerned about the outcome of a vote by the Mesabi shareholders. Mr. Arnold Hoffman and I were in constant communication with the principal shareholders of Mesabi, and as a result of our close contact with the shareholders we were able to assure the officers of Reserve, that the shareholders of Mesabi would overwhelmingly accept and approve the terms of a Settlement Agreement recommended by the Mesabi Board of Directors. In fact, it was not until after I personally assured Mr. William Bryant, an officer of Reserve, in December 1959 that it was an absolute certainty that the shareholders of Mesabi would accept and approve the terms of any settlement recommended by the Mesabi Board of Directors, that negotiations for settlement were initiated and seriously pursued by Reserve. (At p. 3.)

While I am unable to recall with particularity the names and holdings of many of the other stockholders who were contacted during the period February 20, 1960, through March 4, 1960, I attempted to record in my diary many of the names of the Mesabi shareholders or representatives with whom I talked during this time period. I have attached copies of the pertinent diary pages. However, at this late date I am unable to recall the specific holdings of these individuals or representatives, nor am I able to relate many of the names with the owners of record contained in the list of stockholders being supplied by Bankers Trust Company, because the majority of the principal shareholders held their shares in 'street name' and under various nominees. In any event, I do recall that all the people with whom I talked approved the terms of the Settlement Agreement and that their holdings, coupled with the holdings of Messrs. Joseph, Mudd, Fine, the individual directors of Mesabi and the Axe- Haughton Fund, represented more than two-thirds of Mesabi's total 1,323,794 outstanding shares, excluding the 163,570 shares owned by Reserve. * * * (At p. 7.)

The above answer by Gilbert M. Haas clearly shows that shareholder approval was only a technicality, just as much as the Interstate Commerce Commission's final approval was a technicality in Herbert J. Investment Corp. v. United States, 360 F.Supp. 825 (E.D.Wis.1973), aff'd per curiam, 500 F.2d 44 (7th Cir. 1974).

The agreement of February 19, 1960, was signed by Mesabi's authorized officer on February 28, 1960, and by Reserve's authorized officer on March 2, 1960. When the document was signed on the respective dates by Mesabi's officer and Reserve's officer, they knew that shareholder approval was forthcoming and that shareholder approval was just a technicality. Gilbert M. Haas was elected a director of Mesabi in 1958 and he

worked closely with Arnold Hoffman, president of Mesabi, in 1958, 1959, and 1960. The majority's following finding and conclusion regarding stockholder approval were in error:

We add that here stockholder approval, though probable, was surely not a mere formality. Mesabi stockholders had not been a docile group, as the 1958 proxy fight showed, and major blocks of shares were still in the hands of persons associated with old management. Furthermore, Mesabi had, on the record date for the vote, over 2700 individual and 250 institutional shareholders. Most of the shareholders had fewer than 100 shares, and no individual shareholder owned more than 37,154 shares directly. Since Mesabi had agreed to an absolute majority vote, non-voting shares were in effect voted against the agreement. While Mesabi's board of directors might have been convinced that those who voted would vote for the agreement, the failure, through disinterest or inadvertence, of small shareholders to vote could have prevented ratification and must be considered a risk to final approval of the agreement. In fact, the agreement received the vote on only 87% of the eligible shares, not the 99.9% plaintiff has claimed. (Emphasis supplied.)

They are completely contrary to Gilbert M. Haas' statement. The majority's finding that 'the failure, through disinterest or inadvertence, of small shareholders to vote could have prevented ratification and must be considered a risk to final approval of the agreement,' the portion I have emphasized in the above quotation, is contrary to Mr. Haas' statement in the record. To substantiate Mr. Haas' statement, there is a reproduction of many pages from his memorandum book showing the names of shareholders he called.

In concluding, it is submitted that it is the record that counts and this dissent is based on the record.

Footnotes:

FN1. The number of shares held by Reserve was increased to 163,570 as a result of a 1959 'stock divided.' It was later discovered that Mesabi did not have sufficient surplus to issue a legal dividend, and the transaction was relabeled a 'stock split' and so entered on Mesabi's books.

FN2. Not included in the listing is the almost $10,000,000 lost- profits claim for the years 1956--1958 which Mesabi was pursuing in arbitration. See Finding of Fact 29.

FN3. While Mr. Tanner likewise testified that Mesabi was deeply concerned about the extent of its tax liability and would not have wanted a more lucrative settlement because the company was cash-poor, we hesitate to accept this observation since this concern is nowhere noted in the minutes of the meeting, and Mesabi paid its shareholders a cash dividend of $3.00 per share, or a total of $3,579,672, in November 1960--after the settlement and before the 1960 taxes were due. The dividend was, in fact, paid over the objection of plaintiff Haas that the cash would be needed for tax purposes. Furthermore, Mesabi floated an issue of 119,322 shares of stock at $60.00 a share in early 1961, which it evidently had no difficulty selling to its shareholders through a rights offering (the stock was priced on the market at approximately $120 when the rights were issued). The prospectus for the rights offering stated that the shares were being sold to create a cash reserve to pay taxes which might be due because of the settlement if the Mesabi shares received were valued at a price higher than 40 3/8.

FN4. Plaintiff's petition originally claimed in the alternative that the shares were received in a tax-free redemption or in exchange for a capital asset. Both theories have been discarded by stipulation and are not before us.

FN5. The Third Circuit decision in White Farm, which reaches a result similar to that we reach, issued subsequent to the preparation of this opinion. While that decision supports our reasoning, we have reached our conclusion independently.

FN6. If the value of the property had increased by the time of taking into income.

FN7. Plaintiff has not questioned defendant's use of the mean between the high and low price at which the shares traded on April 22 as a valid measure of the stock market price on the date, even though the calculation is found in the estate, rather than income tax, regulations. Treas.Reg. § 20.2031--2(b). Defendant's practice has been accepted as valid by the Tax Court in income tax proceedings, and, in the absence of any complaint by plaintiff, we are inclined to follow. See Meyer v. Comm'r, 46 T.C. 65, 106 (1966), modified on other grounds, 383 F.2d 883 (C.A. 8 1967).

FN8. While defendant did not assess the shares at a value exceeding the market price, the fact that the block had substantial nuisance value and might in fact have been controlling if Reserve had pressed its position, tends to indicate that the shares might have had a premium rather than a depressed value. See 10 J. Mertens, The Law of Federal Income Taxation § 59.15 at 53 (1970); Treas.Reg. § 20.2031--2(e).

FN1. Treas.Reg. § 1.451--1(a) (1960) which states in pertinent part:

'* * * Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. * * *' This regulation is issued under Int.Rev.Code of 1954, § 451 entitled 'General Rule for Taxable Year of inclusion.' The focus under § 451 is only upon when income is to be reported. Section 451 is simply an accounting standard used to determine the year in which income is to be reported. The majority seems more concerned with this accounting standard than with what 26 U.S.C. § 1001(b) (1970) above quoted basically provides.

FN2. Consolidated with Amerada Hess Corp. v. Commissioner, 517 F.2d 75.

FN3. The material portions of the agreement of February 19, 1960, were as follows:

'1. Subject to the conditions hereof Mesabi and Reserve shall, at the Closing, execute and deliver an instrument in the form of Exhibit A hereto to amend the Assignment and an instrument in the form of Exhibit B hereto to amend the Mesabi Lease, * * *.

'2. Subject to the conditions hereof Reserve shall, at the Closing, (a) pay to Mesabi $400,000, and (b) assign to Mesabi all of Reserve's right, title and interest in all of the shares of common stock of Mesabi owned by Reserve (which Reserve represents total 163,570 shares). * * *.

'3. Subject to the conditions hereof, Mesabi and Reserve, at or prior to the Closing, shall cause the above-mentioned arbitration proceedings to be terminated. '4. Subject to the conditions hereof, Mesabi and Reserve, at or prior to the Closing, shall (a) stipulate for the dismissal with prejudice of all pending actions or counterclaims of either of them against the other, its present and former officers, directors or stockholders, and (b) cause to be dismissed by stipulation of the necessary parties thereto, or move to dismiss, the

abovementioned Putterman v. Daveler action and take all steps reasonably necessary to secure a prompt dismissal of such action.

'5. Subject to the conditions hereof, effective at the Closing, each party hereby releases the other party, its present and former officers, directors and stockholders in whatever capacity, from all claims, demands, actions or causes of action of any kind or nature, * * *.

'8. Performance of the obligations of Mesabi and Reserve set forth in paragraphs 1 through 5 above are subject to the conditions that approval and authorization shall have been given by the affirmative vote of a majority of all the outstanding shares of Mesabi, excluding from such majority the shares owned by Reserve.

'9. The Closing shall be held on the fifth business day following the close of the meeting of Mesabi's stockholders approving and authorizing the matters covered by this agreement as hereinbefore provided at the office of Republic, Republic Building, Cleveland, Ohio, or at such other time and place as Mesabi and Reserve shall theretofore mutually agree. If the Closing is not held, this agreement shall become null and void and shall be without prejudice to Mesabi, Reserve, Armco and Republic, and their respective present and former officers, directors and stockholders.'

FN4. Made part of the record by Plaintiff's Motion for Partial Summary Judgment, filed October 20, 1971. See, also, pages 7 to 11 of the uncontradicted Affidavit of Gilbert M. Haas, attached to said motion as an exhibit. See Rule 88(a) of this court.

Bar L Ranch, Inc. v. Phinney, 426 F.2d 995 (5th Cir. 1970)

United States Court of Appeals, Fifth Circuit.

BAR L RANCH, INC., Plaintiff and Defendant in Intervention-Appellant,

v.

Robert L. PHINNEY, Defendant-Appellee, United States of America, Plaintiff in

Intervention-Appellee.

No. 27836.

May 14, 1970.

Suit by corporate taxpayer for refund of a delinquency penalty wherein government sought judgment for an additional tax, penalty, and interest allegedly due. On remand, after judgment in favor of government, 272 F. Supp. 249, was affirmed, 400 F.2d 90, the United States District Court for the Southern District of Texas, at Houston, 300 F.Supp. 839, Joe McDonald Ingraham, J., sustained government's petition with respect to amount of deficiency, and appeal was taken. The Court of Appeals, Dyer, Circuit Judge, held, inter alia, that when it was shown that obligors on notes and accounts receivable were insolvent on day corporate taxpayer transferred its only asset to promisee, in return for which latter transferred indebtedness to taxpayer, commercial practicalities and realities dictated that taxpayer had met its burden of showing that such obligations were not worth their face value and that, for purposes of computing capital gain, a valuation at face was arbitrary.

Reversed and remanded.

Before THORNBERRY, DYER and CLARK, Circuit Judges.

DYER, Circuit Judge.

In reporting the amount of capital gain realized in a transaction in which it received a note and accounts receivable having a combined face value of $118, 100.07, taxpayer valued the note and accounts at substantially below their face. The Commissioner of Internal Revenue determined they should be valued at their face value. The District Court found that the taxpayer failed to show the incorrectness of the Commissioner's assessment and the correct value upon which the tax should have been assessed and entered judgment for the Government. We reverse and remand.

Bar L Ranch sued for refund of a delinquency penalty in the amount of $403.12 which had been incurred as a result of the late filing of its income tax return for its fiscal year ending April 30, 1962. The United States intervened, seeking judgment for an additional $25,515.37 in tax, penalty, and interest allegedly due from Bar L for the same fiscal year.

The District Court held that Bar L was not entitled to recover the $403.12 penalty imposed for late filing of its return. It further held that the Commissioner's assessment of the additional tax and penalty was valid and timely. Bar L Ranch, Inc. v. Phinney, S.D. Tex. 1967, 272 F.Supp. 249. This Court affirmed and remanded for a determination of the amount of deficiency. Bar L Ranch, Inc. v. Phinney, 5 Cir. 1968, 400 F.2d 90.

A nonjury trial was held on that issue and the District Court sustained the Government's position that the note and accounts receivable should be valued at their combined face value. 300 F.Supp. 839. This appeal followed.

The facts concerning the amount of the deficiency were largely stipulated. [FN1] Bar L Ranch is a Texas corporation wholly owned and controlled by Earl N. Lightfoot. Mr. Lightfoot also owns all the outstanding capital stock of Earl N. Lightfoot Paving Co. (Paving Co.), which in turn owns all the stock of Earl Lightfoot Construction Corp.

In the course of its business Paving Co. became heavily indebted to John Young Company (Young), a supplier of paving materials. Consequently, on February 26, 1960, Paving Co. and Lightfoot, individually, executed a promissory note for $97,059.03 to Young, secured by a chattel mortgage on Paving Co.'s equipment. Paving Co. defaulted on its payment to Young, and in March, 1962, Young filed suit against Paving Co. and Lightfoot individually for $118,100.07, representing the balance of $66,313.54 owed on the promissory note and $51,786.53 owed on open accounts. Mr. Lightfoot was also personally liable on the open accounts.

About six weeks later, in April, 1962, Lightfoot caused Bar L Ranch, the taxpayer, to transfer its only asset, 51.576 acres of land and improvements, to Young. In exchange, Young transferred to Bar L the indebtedness on the promissory note and the open accounts, but excluded therefrom accounts totaling $16,550.17. The amount so excluded equaled the outstanding mortgage on the acreage, which Young assumed. As a result of these transactions, Young dismissed its lawsuit against Paving Co. and Light-foot. [FN2]

The adjusted basis of the land transferred by Bar L to Young was $45,920.74. On its tax return for the fiscal year ending April 30, 1962, Bar L reported the transaction as a sale of its land at a price of $50,000.00, resulting in a reported capital gain of $4,353.86. [FN3] Bar L's accountant testified that the $50,000.00 selling price was fixed by him as being what he considered a fair price and to show a small profit on the sale.

In his statutory notice of deficiency the Commissioner computed the increase in Bar L's taxable gain on the transaction as follows:

Value of note and

account received $101,549.90

Liability on property

assumed by purchaser 16,550.17

Amount realized	$118,100.07
Adjusted basis of property sold	45,920.74
Capital gain corrected	$ 72,179.33
Capital gain reported	4,353.86
Capital gain increased	$ 67,825.47

The increase in capital gain resulted in an alleged tax deficiency of $16,956.36, which, with penalties and interest, totals the $25,515.37 in controversy in this suit.

The question for determination by the District Court was whether the note and accounts receivable should be valued at their face value ($118,100.07) or at a much lower figure as contended by Bar L.

The District Court held that the burden was on the taxpayer not only to show that the Commissioner's determination was computed in an arbitrary manner, but also to establish the correct value upon which the tax should have been assessed. The Court then went on to hold that Bar L had not met either of these burdens.

We think the double-pronged burden of proof exacted of the taxpayer by the District Court was too stringent in view of the nature of the proceedings here involved. Of course we agree with the District Court that the Commissioner's determination of a deficiency is prima facie Correct and that the burden is on the taxpayer to prove to the contrary. E.g., Helvering v. Taylor, 1935, 293 U.S. 507, 515, 55 S.Ct. 287, 79 L.Ed. 623; Cummings v. Commissioner, 5 Cir. 1969, 410 F.2d 675; United States v. Lease, 2 Cir. 1965, 346 F.2d 696; Price v. United States, 5 Cir. 1964, 335 F.2d 671. And the law is settled that in a Tax Court proceeding for redetermination of a deficiency the taxpayer has met his burden and is entitled to prevail after establishing that the determination is arbitrary, but that in a suit for refund in the District Court the taxpayer must show, in addition to the arbitrariness of the Commissioner's determination, exactly how much the Government has unjustly withheld from him before he can prevail. E.g., Helvering v. Taylor, supra; Bicknell v. United States, 5 Cir. 1970, 422 F.2d 1055 (February 16, 1970). In the instant case, however, the taxpayer did not file a petition in the Tax Court for redetermination of the deficiency nor did taxpayer pay the deficiency and sue for refund in the District Court. Instead, as to the amount in controversy on this appeal, the taxpayer sat back and waited for the Government to institute (by way of counterclaim) a suit for collection. It was not until that point that taxpayer challenged the correctness of the Commissioner's determination.

We have found only one Court of Appeals case, United States v. Lease, 2 Cir. 1965, 346 F.2d 696, which discusses the burden of proof on a taxpayer who challenges the correctness of a tax assessment as a defense in a collection suit. The Second Circuit concluded there that the taxpayer has the easier burden of proof to

show only that the Government computations are arbitrary. The Court said the burden is then upon the Government to show whether any deficiency exists, and, if so, in what amount; it is not incumbent upon the taxpayer to prove the correct amount of the tax which he did owe or the correctness of the item concerned. Accord, Spivak v. United States, S.D.N.Y.1966, 254 F.Supp. 517 525, aff'd, 370 F.2d 612, cert. denied, 387 U.S. 908, 87 S.Ct. 1690, 18 L.Ed.2d 625 (which, like the instant case, involved a counterclaim by the Government).

Requiring taxpayers in collection suits to meet the more rigorous burden of proof demanded in refund cases would not be warranted by the rationale of those cases:

> 'Since the action for refund of taxes is in the nature of a common law action for money had and received and is governed by equitable principles, the burden of proof is upon the taxpayer to prove not only that the determination of the tax was wrong, but to produce evidence from which another and proper determination could be made.' David v. Phinney, 5 Cir. 1965, 350 F.2d 371, 376, quoting 10 Mertens Law of Federal Income Taxation § 58A.35, pp. 98-99. (Emphasis added).

We therefore agree with the conclusion of United States v. Lease, supra, that a taxpayer defending a collection suit need only show that the Government's assessment was arbitrary and that the burden is then on the Government to show whether any deficiency exists and, if so, in what amount.

We further conclude that the Bar L Ranch has met that burden in this case. [FN4] In computing capital gain or loss, the amount realized from sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Int.Rev.Code of 1954, § 1001(b). The fair market value of the note and accounts receivable is therefore the pivotal question.

Fair market value is measured by what a willing buyer would pay a willing seller when neither is under any compulsion and both are reasonably informed as to all relevant facts. Willow Terrace Development Co. v. Commissioner of Internal Revenue, 5 Cir. 1965, 345 F.2d 933, cert, denied, 382 U.S. 938, 86 S.Ct. 389, 15 L. Ed.2d 349; Anderson v. Commissioner of Internal Revenue, 5 Cir. 1957, 250 F.2d 242, 249, cert. denied, 356 U.S. 950, 78 S.Ct. 915, 2 L.Ed.2d 844; French Dry Cleaning Co. v. Commissioner of Internal Revenue, 5 Cir. 1934, 72 F.2d 167. Bar L contended in the District Court and on appeal that since both the obligors on the note and accounts receivable (i.e., Mr. Lightfoot and Paving Co.) were insolvent on the date of the transaction, a purchaser under no compulsion to buy would not even have paid the $33,449.83 [FN5] which Bar L assigned to the note and accounts, much less the face value. The District Court made an implied finding of insolvency [FN6] and found Bar L's argument appealing in theory, but did not think the fact that those liable for the note and accounts were insolvent showed that the Commissioner's determination was arbitrary.

The District Court assumed, despite its realization that the Commissioner's valuation might prove to be erroneous, that the valuation was not arbitrary because

> assigning the note and accounts their face value is inarguably logical. See Anderson v. Commissioner of Internal Revenue, 250 F.2d 242, 248-249 (5 CA1957), cert. denied, 356 U.S. 950, 78 S.Ct. 915, 2 L.Ed.2d 844 (1958); Williams v. Commissioner of Internal Revenue, 45 F.2d 61 (5 CA1930).

300 F.Supp. at 840, n. 1.

However, the two cases cited by the District Court are not persuasive in support of its assumption. Anderson merely stated that 'it was not arbitrary for the Commissioner to determine that the notes representing the sales price of houses had a value equal to their face, since taxpayer was currently collecting them, * * *' Id. at 248. It is noteworthy, too, that the court in Anderson went on to hold that the Tax Court's valuation of the notes at 70 percent of the face value was not clearly erroneous. Williams sustained a valuation of notes at face value only after first determining that the taxpayer had not shown any reason for finding such a valuation wrong. For example, 'No showing was made as to the financial status of the * * * maker of the notes.' Id. at 62.

In determining fair market value for purposes of Section 1001 gain or loss, commercial realities must be given due consideration. Jack Daniel Distillery v. United States, 1967, 379 F.2d 569, 180 Ct.Cl. 308. See generally Miller v. United States, 6 Cir. 1956, 235 F.2d 553; Anderson v. Commissioner of Internal Revenue, supra; Williams v. Commissioner of Internal Revenue, supra. In the absence of countervailing circumstances not here present, we think that when a taxpayer shows that those liable on a note or account receivable are insolvent, the commercial practicalities and realities dictate that he has met his burden of showing that those obligations are not worth their face value and that a valuation at face is arbitrary. [FN7] Especially is this so where, as here, testimony shows that the Internal Revenue Service merely assumed, without investigation, that the face value represented the fair market value. Although a valuation at face may be a reasonable starting place, such a valuation will be held to be arbitrary if evidence of commercial realities is introduced which shows that the valuation is clearly excessive.

One further matter calls for comment. The District Court rejected all evidence tending to show a low market value of the 51.576 acres of land transferred to Young as being irrelevant to the fair market value of the note and accounts received by taxpayer, saying that 'an expert witness offering a reliable appraisal of the note and accounts would have been more helpful.' 300 F.Supp. at 842. We agree that an expert's appraisal of the value of the note and accounts might be preferable. However, as indicated earlier, the burden to establish the fair market value of the note and accounts was on the Government and, therefore, the taxpayer should not have been penalized for lack of such evidence.

Furthermore, we think evidence of the value of the land is relevant in determining the fair market value of the note and accounts received therefor under Section 1001(b). The basis given by the District Court for rejecting evidence of the market value of the land was the language in Section 1001(b) to the effect that the amount of gain realized is measured by the value of the property 'received' (the note and accounts in the instant case). Despite the language of the statute, however, the Supreme Court held in United States v. Davis, 1962, 370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335, reh. denied, 371 U.S. 854, 83 S.Ct. 14, 9 L.Ed.2d 92, that when a husband transferred stock to his ex-wife pursuant to a property settlement agreement in exchange for relinquishment by her of her marital rights, the husband realized a taxable gain that could be computed. Although it recognized the emotion, tension and practical necessities involved in divorce negotiations and resultant property settlements, the Court nevertheless concluded that there was an arm's length transaction between husband and wife, The Court then concluded that the value of the relinquishment of the marital rights could be measured:

It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 189, 130 Ct.Cl.

166, 172 (1954), that the values 'of the two properties exchanged in an arms length transaction are either equal in fact, or are presumed to be equal.' Id. at 72, 82 S.Ct. at 1194; accord, Seas Shipping Company v. Commissioner of Internal Revenue, 2 Cir. 1967, 371 F.2d 528, cert. denied, 387 U.S. 943, 87 S.Ct. 2076, 18 L.Ed.2d 1330 (computing fair market value of shares of stock); Southern Natural Gas Company v. United States, 1969, 412 F.2d 1222, 188 Ct.Cl. 302 (stock); Tasty Baking Company v. United States, 1968, 393 F.2d 992, 184 Ct.Cl. 56 (value of employees' services, past and future, presumed to equal the fair market value of property contributed to employee pension trust.)

The presumed-equivalence-in-value rule of Davis has generally been limited to 'cases involving valuation of property for which there is little or no market.' Seas Shipping Company v. Commissioner, supra, 371 F.2d at 529; Southern Natural Gas Company v. United States, supra, 412 F.2d at 1252. However, there will be 'little or no market' even for shares of stock traded over an established exchange if there are other factors such as the large size of the block in question which the market price does not reflect. Seas Shipping Company v. Commissioner, supra. In such circumstances use of the Davis presumed-equivalence-in-value rule may even be preferable to expert appraisals of the value of the property received. Southern Natural Gas Company v. United States, supra. The instant case is slightly different from Davis and its progeny in that here there is no indication that the parties who were at arm's length bargained over the actual dollar worth of the exchange. That is, no precise dollar worth was assigned to the land at the time of the transfer (at least no such assignment appears from the record). It would, therefore, be inappropriate to give the presumed-equivalence-in-value rule the full presumptive effect given in Davis et al.

However, it is clear from the record as it now stands that Young and Bar L (along with Paving Co. and Mr. Lightfoot) were parties with adverse interests who were at arm's length. It is also clear that there was little or no market established for the note and accounts receivable and that such a market may be difficult to establish even by expert testimony. Therefore, we think, in accordance with the principles of Davis, that the value of the 51.576 acres transferred to Young is a relevant factor to be given consideration in determining the value of the note and accounts received in exchange therefor and that evidence of the value of the land should not be rejected by the District Court.

The judgment is reversed and the case is remanded to the District Court for further proceedings not inconsistent with this opinion.

Reversed and remanded.

Footnotes:

FN1. The statement of facts is pilfered from the District Court opinion.

FN2. The transaction between Young and Lightfoot is not attacked and no attempt is made to treat Lightfoot and his companies as other than separate entities. Of course, Paving Co. was required to report the cancellation of indebtedness to Young as income under Int.Rev.Code of 1954, § 61. The record reflects that this was done.

FN3. The actual figure which results when the adjusted basis ($45,920.74) is subtracted from the selling price fixed by Bar L's accountant ($50,000.00) is $4,079.26. However, the parties stipulated that the reported capital gain was $4,353.86 and this figure was accepted by the District Court.

FN4. This court recognizes that factual determinations are involved in the ultimate question of arbitrariness of the Commissioner's determination of fair market value.

The district court's finding on this ultimate issue, however, is not to be garrisoned by the clearly erroneous rule. Though it has factual underpinnings this ultimate issue is inherently a question of law. Obeisance to the clearly erroneous rule must yield when the facts are undisputed and we are called upon to reason and interpret. This is the law obligation of the court as distinguished from its fact finding duties.

United States v. Winthrop, 5 Cir. 1969, 417 F.2d 905, 910; Maryland Casualty Company v. State Bank & Trust Company, 5 Cir. 1970, 425 F.2d 979.

FN5. This figure was arrived at by subtracting the $16,550.17 mortgage on the 51.576 acres assumed by Young from the $50,000 selling price fixed by Bar L's accountant.

FN6. See 300 F.Supp. 842, col. I.

FN7. The note involved in this case was secured by a chattel mortgage on Paving Co.'s equipment having a value of $48.627.95. Although the promissors on the note were insolvent, the existence of the mortgage, of course, prevents the note from being valueless as taxpayer claims. However, the indebtedness still outstanding on the note alone was $66,313.54 and the total indebtedness on the note and accounts was $118,100.07. Therefore, while the value of the equipment mortgaged is relevant in determining the fair market value of the note and accounts (at least if the equipment is not subject to superior encumbrances), the existence of the mortgage does not negate the fact of insolvency to the extent that Bar L has failed to establish that the Commissioner's valuation at face value was arbitrary.

Jack Daniel Distillery v. United States, 379 F.2d 569 (Ct.Cl. 1967)

United States Court of Claims.

JACK DANIEL DISTILLERY, Lem Motlow, Prop., Inc.,

v.

The UNITED STATES.

No. 302--63.

June 9, 1967.

Suit for refund of corporation income tax and assessed interest, in which government counterclaimed for income tax and interest previously refunded and for unpaid assessments of income tax and interest. The Court of Claims, Nichols, J., held, inter alia, that distillery's valuation of unbottled inventory constituted the fair market value of such inventory and was properly used by it as a basis for computing its cost of goods sold and income for years in question, and that residuary method of valuing goodwill of distillery business was proper where fair market value of tangible assets and value of the business were firmly established.

Order in accordance with opinion.

Before COWEN, Chief Judge, and LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, Judges.

OPINION

NICHOLS, Judge: [FN*]

This is a suit for refund of corporation income tax and assessed interest in the total sum of $4,274,803.73 for the fiscal years ended April 30, 1958 through 1962. While plaintiff does not claim a refund for the fiscal year ended April 30, 1957, it claims entitlement to a carryover of a net operating loss from such year to the fiscal year ended April 30, 1959. Defendant by counterclaim seeks a judgment for income tax and interest previously refunded in the sum of $559.99 for the fiscal years 1958 through 1960, and for unpaid assessments of income tax and interest in the sum of $211,838.02 for the fiscal years 1961 and 1962.

With the approval of the trial commissioner, the trial has been limited by agreement of the parties to the issues of law and fact relating to the right of each party to recover, reserving the determination of the amounts of recovery, if any, for further proceedings.

Plaintiff, a newly-formed Tennessee corporation, acquired the stock of a predecessor Tennessee corporation of the same name (hereinafter called Old Jack Daniel) on August 29, 1956, for a total purchase price of $18 million, with a down payment of $5.4 million in cash and the balance of $12.6 million in negotiable promissory notes. On September 17, 1956, plaintiff liquidated Old Jack Daniel and thereby acquired all its

assets and assumed its liabilities, and thereafter carried on the whiskey distillery business previously operated by Old Jack Daniel at Lynchburg, Tennessee. Plaintiff had been incorporated by its parent, Brown-Forman Distillers Corporation, on August 25, 1956, for the specific purpose of acquiring the Old Jack Daniel stock and then liquidating Old Jack Daniel. There are two issues in this case:

1. The fair market value of the inventory of barreled whiskey, the tax-paid whiskey in bottling tanks, and the goodwill acquired by plaintiff from Old Jack Daniel for purposes of section 334 of the Internal Revenue Code of 1954; and

2. Whether the amount of $3.5 million paid to plaintiff by its parent, Brown- Forman Distillers Corporation, on August 28, 1956, was a loan or a contribution to capital.

VALUE OF UNBOTTLED INVENTORY AND GOODWILL

The point of beginning for the valuation issue is section 334(b)(2) of the Internal Revenue Code of 1954, 26 U.S.C. § 334(b)(2) (1964). It provides that if property is received in complete liquidation of a subsidiary under section 332(b) and certain other criteria are met (all of which occurred in the instant case), the basis of the property received shall be the adjusted basis of the stock with respect to which the distribution was made. Treasury Regulations § 1.334--1(c)(4)(viii) (1954 Code), 26 C.F.R. § 1.334-- 1(c)(4)(viii) (1961) provides, for the purposes of this case, that the adjusted basis of the stock shall be allocated among the tangible and intangible assets received in proportion to the net fair market value of the assets received. [FN1] The parties have stipulated the value of all items other than the three in dispute. The undisputed assets acquired by plaintiff in the liquidation of Old Jack Daniel including the distillery plant, buildings and equipment, land, cash, accounts receivable, raw materials and supplies, and others, and as to these defendant has accepted as fair market value the amounts shown on plaintiff's books. The valuations of the parties concerning the disputed items, and the cost basis of such assets on the books of Old Jack Daniel, are as follows:

	Defendant	Plaintiff	Cost to Old Jack Daniel
Whiskey in barrels	$3,788,000	$11,571,381.51	$3,249,294.87
Whiskey in bottling tanks	17,200	26,248.86	16,256.55
Goodwill	6,706,000	2,507,998.30	0

The wide gap between the valuations given by the parties results in part from a use of two completely different methods of valuation and in part from a difference as to what incidents of ownership are part of fair market value.

Jack Daniel whiskey is and was what is known in the distilling industry as an irreplaceable whiskey, that is, it is a unique whiskey which has gained a reputation for its distinctive taste. Jack Daniel, being considered irreplaceable, was not sold on the bulk whiskey market. Examples of irreplaceable whiskeys were such bourbons as Old Grand-Dad, Old Forester, and Old Fitzgerald. Jack Daniel was even more distinctive than such irreplaceable bourbons, because the unique method by which it was produced gave it a taste distinct from both rye and bourbon, and it was unlike any other whiskey on the market in 1956. It was also, at that time, the highest priced domestic whiskey.

Some years prior to 1956, the distilling industry, believing that the market price for bulk whiskey did not adequately reflect the value of irreplaceable whiskeys, entered into an agreement with insurance underwriters to use a new method of valuing irreplaceable whiskey for insurance purposes. The method used was to take the case price of the whiskey in glass and subtract from this, excise taxes, bottling costs, and other charges as yet unincurred with respect to the bulk inventory. The resulting figure was considered to be the value of the matured whiskey in barrels and bottling tanks. The value of freshly distilled whiskey was established on the basis of production cost. The intermediate age whiskey was valued by prorating, according to age, the difference between the values of the mature whiskey and the fresh whiskey.

When sale negotiations began between the Old Jack Daniel stockholders and the representatives of Brown-Forman, the sellers' asking price for the Old Jack Daniel stock was placed at $20 million. This amount was arrived at by two methods. First, the anticipated combined earnings for Old Jack Daniel and its sales affiliate, Nashville Sales Company, for the fiscal year 1956 were $2 million. The Old Jack Daniel stockholders considered that a sales price of 10 times earnings, or $20 million, was reasonable. The second method was that the net tangible assets of Old Jack Daniel were valued at $15 million, and to this was added $5 million as the value of goodwill. In determining the net tangible asset value of Old Jack Daniel, the bulk inventory was valued by the same method as that used for insurance valuation.

After the initial negotiating session, Brown-Forman verified to its satisfaction the valuation given the tangible assets. In order to determine whether, for tax purposes, it could write up the unbottled inventory to the insurance value, it consulted its regular outside auditors, Lybrand, Ross Bros. & Montgomery. The auditors reviewed the projected income and cash flow, and determined that the valuation given the inventory would yield an extraordinary gross profit. They then advised Brown-Forman that they considered the proposed valuation a correct accounting method for determining basis under s § 334(b)(2) of the Internal Revenue Code of 1954.

After further negotiations, Brown-Forman and the Old Jack Daniel stockholders agreed on a purchase price of $18 million, and the sale of the Old Jack Daniel stock was consummated on August 29, 1956, with the subsequent liquidation of Old Jack Daniel on September 17, 1956.

In accordance with the market value insurance formula, plaintiff valued (as did Old Jack Daniel) the transferred inventory of barreled whiskey (3,125,277.06 original proof gallons) at $11,571,381.51, and the transferred inventory of whiskey in bottling tanks (1,350 regauged proof gallons) at $26,248.56, for a total valuation of $11,597,630.37, all in the manner detailed in findings 42 through 45.

In comparing its income tax liability for the fiscal period August 25, 1956 to April 30, 1957, and the fiscal years ended April 30, 1958--1962, plaintiff used as its basis for computing the cost of the unbottled inventory acquired by the liquidation of Old Jack Daniel the aforementioned valuation used for determining insurance values. These values were were entered on its books on September 17, 1956. Plaintiff filed timely income tax returns for the fiscal period ended April 30, 1957, and the fiscal years 1958--62, showing taxable income or loss and tax paid, as follows:

Taxable Year	Taxable Income (or Loss)	Tax Paid Per Return
1957	($377,667.55)	None
1958	(1,080.17)	None
1959	348,478.49	$ 175,708.81
1960	2,318,166.67	1,199,946.67
1961	3,940,388.52	2,043,502.03
1962	5,874,356.32	3,049,165.29
Total	$12,480,309.83	$6,468,322.80

The Internal Revenue Service audited plaintiff's returns for the fiscal years 1958--62, and determined the following deficiencies:

Taxable Year	Income Tax Deficiency
1958	$1,170,404.69

1959 ..... 1,223,537.00

1960 ..... 731,917.64

1961 ..... 324,146.59

1962 ..... 23,081.62

$3,473,087.54

The foregoing deficiencies resulted from the Commissioner's use of the Old Jack Daniel cost basis for the assets, rather than the basis recorded on plaintiff's books on September 17, 1956, in computing cost of goods sold and allowances for depreciation of the assets acquired from Old Jack Daniel. [FN2] The 1959 deficiency also results in part from the disallowance of a deduction for a net operating loss carryover, based on plaintiff's original calculation that it incurred losses for fiscal 1957 and 1958, such losses giving rise to a deduction in 1959. In recomputing plaintiff's income for fiscal 1957 and 1958, the Commissioner determined that plaintiff had income for those periods.

Before this court, the defendant has retreated, to a degree, from the original position of the Commissioner that the fair market value of the bulk whiskey was the cost basis on the books of Old Jack Daniel. To the Old Jack Daniel cost basis, $3,265,551, defendant has added a 'future worth factor' of $539,649, computed at 6.5 percent per year, compounded semiannually for each seasonal distillation, for a total valuation of $3,805,200. [FN3] The 'future worth factor' was intended to take into account interest on the original investment as the whiskey matured and the storage and other charges incurred on the inventory as it matured.

The above outlined methods of valuation are the factual bases for the divergent positions of the parties. The legal definition of fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts. Wood v. United States, 29 F.Supp. 853, 89 Ct.Cl. 442 (1939). [FN4]

The principal difficulty in valuing the unbottled whiskey inventory is that because Jack Daniel is distinctive and irreplaceable, it has never been sold in bulk. Since its value has never been tested by sales in the market place, the determination of fair market value of the unbottled inventory will necessarily be constructive in nature, based upon careful consideration of the reliable and relevant testimony and evidence pertaining to what price would have been reached on September 17, 1956, between a willing seller and a willing buyer, both reasonably informed as to the facts. Old Jack Daniel proposed the insurance value as being the fair market value of the unbottled inventory, and this value was accepted by the representatives of Brown-Forman. [FN5] Brown- Forman's regular independent auditors determined that a purchase of the whiskey inventory at the insurance values would yield an extraordinary before-tax profit, and that the valuation was therefore a reasonable one.

In the trial of this case, R. L. Buse, Jr., president of both a whiskey brokerage company and a distillery company, Vernon O. Underwood, president of a large whiskey wholesaler, and G. K. McClure, treasurer of

Stitzel-Weller Distillery, a whiskey distiller, all testified that, in their opinion the insurance value was the fair market value of the Jack Daniel inventory. In addition, Buse and Underwood testified that in 1956 they would willingly have purchased (if financing could have been obtained), or participated in a joint venture to purchase, the Jack Daniel inventory at the insurance value, assuming that they would have the right to sell the same under Jack Daniel labels.

The testimony is convincing that the Jack Daniel inventory could have, in 1956, been sold to a third party or parties for the insurance valuation given the inventory, if the purchaser or purchasers were given the right to sell the same under Jack Daniel labels.

Defendant makes two attacks on plaintiff's valuation which raise questions about what elements of value attach to fair market value.

As stated above, plaintiff's witnesses, in considering the fair market value of the unbottled inventory, assumed that their purchase of the inventory would have included the right to market the whiskey under the Jack Daniel labels. Defendant contends that the use of the Jack Daniel labels is an intangible and should not be included in the valuation of a tangible asset. [FN6]

The testimony of plaintiff's witnesses indicated that the addition of the right to use the Jack Daniel label would substantially increase the value of the unbottled inventory. For purposes of this opinion, it can be conceded that the sale of the unbottled whiskey does not automatically carry with it the right to use the Jack Daniel label. The question then arises whether the value attributable to such right has to be excluded from the fair market value.

In the ordinary commercial situation, when an item is manufactured and put into inventory, it is ready to be sold to the consuming public. If it is a unique item, the value attributable to a name or trademark will have adhered to the item at that point in time. For example, a Cadillac automobile or a Baldwin piano has a certain value when produced, and the value of the name would be virtually inseparable from the value of the item as a whole.

Of course, the whiskey inventory had a value even without the Jack Daniel name, albeit a lower one. As to the bottled inventory, defendant accepted the value placed thereon by plaintiff. Thus, defendant (at least by implication) has conceded that the whiskey in labeled bottles had the market value which plaintiff contends should be placed on the matured whiskey (and prorata on the maturing whiskey) in barrels and in bottling tanks, less the cost of bottling and other unincurred costs. Defendant's distinction between the unbottled and bottled inventory (the latter carrying the right to use the Jack Daniel labels) is in essence the difference between finished stock and work in process. [FN7] This distinction is not entirely inapt, the unbottled inventory having some characteristics of work in process. The inventory had to age for a certain number of years and then be bottled and labeled before the analogy between Jack Daniel whiskey and a Cadillac would be full and complete.

On the other hand, the unbottled Jack Daniel inventory is unlike the usual work in process in many respects. The addition of the word 'Cadillac' to an automobile chassis or 'Baldwin' to a piano leg enhances the value of the object very little, if at all. This is in complete contrast to the Jack Daniel situation. The evidence indicates that the unique qualities of Jack Daniel whiskey are generated in specialized distillation and leaching processes accomplished prior to its being placed in barrels for aging, and that the holding of the same in barrels for aging does not fit the concept of work in process in the usual sense. In addition, ordinary

work in process might have little liquidation value, but only a salvage value, whereas the Jack Daniel inventory had a substantial liquidation value with or without the Jack Daniel name.

Taking all the above factors into consideration, it is apparent that, even though the unbottled inventory could technically be called work in process, it had already reached a stage where its distinctiveness had given its name a value inseparable in fact, if not in law, from the item itself. In the world of commercial reality, the fair market value of the inventory included the right to use the Jack Daniel label. Indeed, no businessman desiring to maximize his profit would have entertained the notion that the whiskey would be sold, unbranded, on the bulk market. The fair market value test is predicated in part on the highest and best use which can be made of the subject matter, and the evidence certainly shows that the Jack Daniel whiskey would in 1956 have sold at the highest price under its own labels. In assessing fair market value, due consideration should be given to the realities of commercial transactions, and particularly to the plain facts concerning the best use to be made of the subject matter of a sale. As a recognized commentator in the tax field has said: 'Fair market value in essence means sound value; it is the price for which the owner would hold out if he could.' [FN8] It would seem to have been sound commercial practice for the Old Jack Daniel stockholders and Brown-Forman to place the value on the unbottled inventory, which they did. It must be concluded that the fair market valuation has to include, in this instance, any value attributable to the use of the Jack Daniel trade name and labels in connection with any disposition of the unbottled inventory transferred by liquidation of Old Jack Daniel.

The second problem raised by defendant is whether an asset can have a different fair market value in varying context, i.e., whether an asset has a different value as part of a sale of a going business than it would have if sold separately; and, if that question is answered affirmatively, whether the valuation of the unbottled inventory is affected by that factor in this case.

In two cited decisions, the Tax Court rejected valuations of the Commissioner which were based on the liquidation value of the asset, i.e., the amount the asset would bring if sold separately from the business. Kraft Food Co., 21 T.C. 513 (1954), rev'd on other grounds 232 F.2d 118 (2d Cir. 1956); Philadelphia Steel & Iron Corp., 23 T.C.M. 558 (1964), aff'd per curiam, 344 F.2d 964 (3d Cir. 1965). Defendant argues that these cases support the general proposition that all assets sold as part of a going business should be valued in that light. Therefore, if an asset is shown to have a lower value if sold as part of a going business, the lower value should be the fair market value for purposes of § 334(b)(2).

However, both the above cases assigned the assets in dispute a fair market value higher than the liquidating value. Plaintiff therefore claims that these cases support the general proposition advanced by it that fair market value must be determined with reference to highest and best possible use of the property.

The factual patterns in the two last-cited cases are complex and substantially different from this case, and no hard commitment can or should be made to either party's contention concerning any general principle to be derived from those opinions, especially when it is remembered that determination of fair market value is basically a factual decision, no matter how complicated the reasoning process involved. Even if defendant's interpretation of the two Tax Court opinions is accepted, the value of the unbottled inventory as part of a going business was at least that reasonably and in good faith given it by the parties to the arm's-length sale of all of the Old Jack Daniel stock. Moreover, defendant's method of valuation has no relationship to either a liquidating fair market value or a going business fair market value.

The potential profit to plaintiff from purchasing the inventory at insurance value was extremely high, as was

shown by the profit projections of plaintiff's auditors. The actual before-tax profit realized from the sale of the inventory was $6.2 million, more than a 50 percent return on the original investment in the whiskey inventory, and more than a 25 percent return on total costs (except taxes). Defendant has not shown why this valuation does not, in fact, represent the going business value of the unbottled inventory. [FN9] Defendant contend that the valuation of the individual monthly distillations was arbitrary because plaintiff showed a loss upon the disposition of a substantial portion of the unbottled inventory. While it may be true that the valuation placed on monthly distillation did not reflect fair market value, the issue is the value of the inventory as a whole, and the evidence makes it abundantly clear that the overall valuation is fair. In this context, plaintiff has provided a proper basis for valuation. See Kraft Foods Co., supra, 21 T.C. at 592--593.

Defendant has raised other minor attacks on plaintiff's method of valuation. It argues that the $6.2 million profit does not justify plaintiff's valuation of the whiskey when one considers that plaintiff had to pay almost $20 million and wait 5 years to realize the gain. While acknowledging that there is a certain factor for the use of capital which is not reflected in plaintiff's profit figures, it is concluded that such factor is not nearly as great as defendant suggests. In the first place, the amount of capital tied up because of the inventory purchase was $11.9 million, not $20 million. An interest allocation based on the total purchase price of $18 million [FN10] would be proper only if the other assets had no independent economic value prior to the sale of the unbottled inventory. That is manifestly not the case here. Secondly, the capital was being returned to plaintiff throughout the period when the inventory was being bottled and sold, and not all in one lump sum at the end of the period, as defendant suggests. Even taking into account an interest factor for the use of capital, plaintiff still obviously made a substantial profit on its total costs for the unbottled inventory.

Defendant also points out that the profit which Old Jack Daniel would have made if it had sold the $12 million whiskey inventory separately would have been $8.5 million, which it terms 'grossly excessive,' being a return of approximately 243 percent on the Old Jack Daniel cost of production of $3.5 million. But, if defendant's valuation is accepted, plaintiff had a before-tax profit of 350 percent of its original investment, and approximately 55 percent of its total costs (exclusive of taxes). In addition, defendant's valuation attributes no gain to Old Jack Daniel from the sale of the inventory as part of the business.

Defendant relies upon United States v. Cornish, 348 F.2d 175 (9th Cir. 1965), but that case does not militate against the conclusion that plaintiff's valuation method was proper. The taxpayer in Cornish used a 'work-back' formula in valuing timber and timber cutting rights. The Court of Appeals rejected the use of a 'work-back' formula for two reasons. First, it took into account the prospect that the taxpayer's partnership would make a larger profit because of the unique sawmills owned by the partnership. This was a factor already taken into account in determining the fair market value of the sawmills, and if also allowed as an element of value for the timber, would result in one element of value being attributed to two assets. Second, it also took into account the prospect that the partners would exercise their unique skills in the future to continue the highly profitable nature of the business. [FN11]

In the instant case the skills necessary to produce the distinctive Jack Daniel whiskey had already been exercised at the time of sale; the remaining factors (aging and bottling) are a rather minor part of the overall operation, and are relatively simple and unskilled operations.

As the testimony and evidence in the present case indicate, the value of the whiskey as Jack Daniel's whiskey adhered to the inventory when it was placed in barrels to age. It had a substantial value at that time as Jack Daniel whiskey. The timber in Cornish had no greater value as such because certain unique skills and operations would ultimately result in an operation more profitable than other sawmills. Factually, Cornish is

in nowise comparable with the Jack Daniel situation.

Defendant's evidence on valuation was presented by an appraiser for the Internal Revenue Service, Robert V. Brown. [FN12] The unbottled inventory valuation was computed by taking the cost of production, $3,265,551, and adding a 'future worth factor' for each seasonal distillation of 6.5 percent, compounded semiannually, for $539,649. The total valuation was thus $3,805,200.

This method of valuation must be rejected, as being purely arbitrary, because it completely ignores the 'market' concept in the term fair market value. Fair market value could in the abstract be higher or lower than cost, but equating cost and market price is grossly inconsistent with the seller's market for Jack Daniel whiskey existing in 1956, and with the general economic conditions prevailing at that time. Defendant here made no attempt to investigate the 'market' and establish a valuation on the basis of same. Since there had been no sales of the unique Jack Daniel whiskey in bulk, the fair market value of the unbottled inventory would have to be established by the expert testimony of persons knowledgeable in market conditions relating to Jack Daniel whiskey. But because there had been no bulk sales of such whiskey, it does not follow that the 'fair market value' standard can be disregarded, and an inapt standard substituted.

The testimony has overwhelmingly established that the unique method of distilling Jack Daniel produced a distinctive whiskey which was in great demand. From this it can be assumed that even as a part of the going business, the fair market value of the unbottled inventory exceeded its cost. Yet defendant, in its valuation method, ascribes no profit to the inventory. The 'future worth factor' is not profit, it is an allowance for additional costs incurred as the inventory matures and a percentage of interest on the capital investment in the inventory.

Defendant attempts to buttress its valuation by reference to buy-back clauses in several contracts made by distillers of irreplaceable bourbons with distributors for the sale of such whiskey in barrels. Such clauses permit the distiller to repurchase the whiskey upon the happening of certain stated events.

There are two plain reasons why defendant's valuation fails to gain weight by reliance on buy-back clauses. First, such clauses only become operable when conditions arise that force the distributor to sell the whiskey. They cannot be considered to establish an open market price, since they only operate in one direction, i.e., by placing a floor but not a ceiling on the barrel price, [FN13] and the contingency against which these clauses are intended to guard is a distress sale which would dump irreplaceable bourbon on the bulk market. Secondly, the barrel sales prices of irreplaceable bourbon under such contracts must have included a profit to the distiller, which, as pointed out previously, defendant has ignored in arriving at its valuation herein.

From all the foregoing, it is concluded that plaintiff's valuation of the unbottled inventory constitutes the fair market value as of September 17, 1956, and was properly used by it as a basis for computing its cost of goods sold and income for the years in question.

The remaining valuation problem relates to the fair market value of the goodwill transferred to plaintiff from Old Jack Daniel. During the negotiations for sale of the Old Jack Daniel stock, the goodwill was agreed to have a value of $2.5 million, and approximately this amount was entered on plaintiff's books as goodwill when Old Jack Daniel was liquidated. Plaintiff's approach to the valuation was essentially what defendant characterizes as 'residual,' i.e., when the fair market value of the tangibles is established, the remaining amount which the purchaser is willing to pay for the business is attributable to the goodwill.

Defendant arrived at a valuation for the intangibles by capitalizing anticipated excess earnings. Briefly stated, this was done by obtaining an average after-tax net profit (using plaintiff's earnings projections and deducting estimated average costs); applying a 6.5 percent rate to defendant's net tangible valuation to obtain a return on the tangibles; then deducting the return on the tangibles from the total projected income. The resulting sum is considered the earnings attributable to the intangibles. This amount was then multiplied by eight (standing for the estimated length of time that it would require a competitor to market Tennessee whiskey) and then reduced to its present worth by discounting it at 5 percent.

The residuary method, though lacking in precision for use in all cases, may in a proper case be accepted as the reasonable way to value goodwill. When it is the method actually used in good faith by the parties to the sales transaction, as in the present case, and when such parties have reasonably established the value of all other assets, there appears to be no compelling reason for rejecting it. The residuary method has been used in a substantial number of cases and appears clearly to be the proper method for this case, since the fair market value of the tangible assets and the value of the business are and were firmly established. See Philadelphia Steel & Iron Corp., supra; 10 Mertens, supra, 59.37 and cases therein cited. The parties actively bargained in good faith over the value of the goodwill after they had settled on the value of the other assets. The sellers originally wanted $5 million, the buyer originally offered $1 million, and they finally agreed upon $2.5.

million. TREATMENT OF $3.5 MILLION PAID TO PLAINTIFF BY BROWN-FORMAN IN

EXCHANGE FOR A PROMISSORY NOTE.

The defendant has counterclaimed for the tax [FN14] attributable to amounts accrued on plaintiff's books for the fiscal period and years involved as interest on a promissory note which was issued to Brown-Forman in return for $3.5 million of the $5.5 million in cash received from Brown-Forman when plaintiff was incorporated, $5.4 million of which was in turn paid over to Old Jack Daniel stockholders as part payment for the Old Jack Daniel stock. Defendant contends that the $3.5 million was a capital contribution rather than a loan, and that therefore plaintiff incorrectly accrued the interest deductions.

The question whether a receipt of funds by a subsidiary corporation from its parent is a loan [FN15] or a capital contribution has given rise to much litigation, resulting in apparently conflicting judicial opinion. To state the problem is simple: did the words used by the taxpayer actually and accurately describe the economic relationship of the parties, that is, did the parties intend, at the time of the issuance of the instrument, to create a real debtor-creditor relationship?; [FN16] to arrive at an answer is the difficult task.

This area is devoid of blackletter law, as is true of any tax inquiry seeking the 'substance' [FN17] of a given transaction. In fact, '(t)here is no one characteristic * * * which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.' John Kelley Co. v. Commissioner of Internal Revenue, 326 U.S. 521, 530, 66 S.Ct. 299, 304, 90 L.Ed. 278 (1946); also see Moughon v. Commissioner of Internal Revenue, 329 F.2d 399, 401 (6th Cir., 1964); Byerlyte Corp. v. Williams, 170 F.Supp. 48, 53 (D.C.N.D.Ohio, 1958), aff'd on rehearing 170 F.Supp. 60 (D.C.N.D.Ohio, 1959), reversed and remanded on other grounds 286 F.2d 285 (6th Cir., 1960) ('In the plethora of precedent on this issue there is to be found no single rule, principle or test that is controlling or decisive of the question whether advances by stockholders to a closely held or solely owned corporation are to be considered as debts or contributions to capital.' at 53). Therefore, the Court must consider the specific facts of this case to determine the plaintiff-taxpayer's relationship with Brown-Forman in regard to the advance in question. The Court must examine these facts in light of the signposts that have previously been laid out, [FN18] always

recognizing that the burden of establishing that the advance was a loan is upon the taxpayer. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440, 54 S.Ct. 788, 78 L.Ed. 1348 (1934); White v. United States, 305 U. S. 281, 292, 59 S.Ct. 179, 83 L.Ed. 172 (1938); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905 (7th Cir., 1959).

While it may be somewhat repetitious, we will again state those introductory facts specifically bearing on the Government's counterclaim.

Early in 1956 Brown-Forman learned that Old Jack Daniel might be for sale. This prospect interested Brown-Forman as it coincided with its interest to diversify and expand its operations. Brown-Forman first offered to buy the assets of Old Jack Daniel but the latter's shareholders were only willing to consummate the purchase of Old Jack Daniel by a sale of their stock. Brown- Forman agreed to this format, setting up a subsidiary, New Jack Daniel, the plaintiff-taxpayer, to purchase the stock for $5.4 million in cash and $12.6 million in secured, negotiable, promissory notes. Old Jack Daniel was thereafter to be liquidated into New Jack Daniel.

When New Jack Daniel was incorporated, Brown-Forman decided that in addition to the Old Jack Daniel assets, New Jack Daniel would need a permanent equity capitalization of $2,000,000 in order to carry on the distillery business. This sum was paid by Brown-Forman in cash and in return it received all of New Jack Daniel's stock. At the same time Brown-Forman loaned New Jack Daniel $3,500,000 and received in return its subordinated note for the same amount.

In 1956, in order to expand and diversify its activities, Brown-Forman borrowed $19,600,000 (with $9.95 million of it being used to pay off prior long-term debt) from its usual banking sources. At that time Brown-Forman showed the $3.5 million of the new loan would provide the funds for the loan to New Jack Daniel. The additional $9.65 million loan was obviously made with this in mind.

We now turn to the specific facts and applicable standards which have led us to conclude that Brown-Forman did in fact lend $3.5 million to New Jack Daniel. Our decision, favoring New Jack Daniel, is so made because we consider the facts tending to show the note represented a true debt to outweigh those suggesting the opposite conclusion.

Brown-Forman and New Jack Daniel clearly intended to create a valid debtor-creditor relationship here. The note received by Brown-Forman contained an unqualified promise to repay the principal and interest on or before a fixed maturity date, regardless of New Jack Daniel's earnings. Haffenreffer Brewing Co. v. Commissioner of Internal Revenue, 116 F.2d 465, 468 (1st Cir., 1940), cert. den. 313 U.S. 567, 61 S.Ct. 942, 85 L.Ed. 1526 (1941). During the period when the $3.5 million note was outstanding, Brown-Forman represented it as a loan on its books, in its reports to the Securities and Exchange Commission and the American Stock Exchange, to its lending institutions, and to its stockholders. Interest was regularly accrued by New Jack Daniel on its books and interest receivable was regularly accrued by Brown-Forman and both companies so reflected the interest on the tax returns.

It is true, as the Government stresses, that the note in question was subordinated to the purchase money notes given to the Old Jack Daniel stockholders. However, the note was not subordinated to the claims of other creditors. [FN19] 'Moreover, that the indebtedness was subordinated is outweighed (by the other factors herein, [FN20] by the lack of other claims and the obvious benefit in facilitating any future refinancing.' Bright-on Recreations, Inc. v. Commissioner, 20 CCH Tax Ct. Mem. 127, 136 (1961). This latter consideration is borne out by the fact that New Jack Daniel, soon after the loan from Brown-Forman, was

able to borrow an additional $300,000 from one of the banks which participated in the loan to Brown-Forman, giving its unsecured note in return, as to which the $3.5 million note to Brown-Forman was not subordinated. In fact, the bank President testified that if the plaintiff had requested additional credit at the time when the $300,000 loan was made it would have been granted. We must also stress the fact that Brown-Forman was not required to make any further advances to New Jack Daniel, Cf. Affiliated Research, Inc. v. United States, 351 F.2d 646, 173 Ct.Cl. 338 (1965) (where after the initial advances had been made the corporation still required further advances on several occasions) and New Jack Daniel was able to repay the loan in full in 1963. Oak Motors, Inc. v. Commissioner, 23 CCH Tax Ct. Mem. 520, 524 (1964); Cf. Affiliated Research, supra, (where the advances, with small exceptions, were never repaid).

Another factor that could be on the Government's side of the scales is the fact that the note was unsecured. The Government contends that this shows Brown-Forman really subjected its money to the risk that New Jack Daniel would not succeed in its venture, [FN21] though this risk would materialize only if the failure to succeed was such that the equity capital ($2 million) was first wiped out. 'To say that the advances were * * * placed at the risk of the business does not help (the Government). All unsecured loans involve more or less risk. On all available information, the risk here was a good one.' [FN22] The value of the aging whiskey inventory, as we have determined, was appreciating at a rate of more than $250,000 a month and New Jack Daniel had almost $3 million in working capital. Of the $5.5 million received from Brown-Forman, $5.4 million was paid to the Old Jack Daniel stockholders, leaving a balance of $100,000. New Jack Daniel received $2,845,574.76 in cash upon the liquidation of Old Jack Daniel. In addition, there were also received accounts receivable worth $527,630.53 and a life insurance policy with a cash surrender value of $17,432.85. By 1956 orders from distributors exceeded the supply of Jack Daniel whiskey and allocation had to be made among the distributors, in part because of a production cutback in 1954. The Jack Daniel whiskeys were then the highest priced domestic whiskeys with the highest profit to the distiller.

Here there was a reasonable expectation that the amounts advanced would be repaid (Finding 68) and Brown-Forman had contributed a substantial amount of equity capital to plaintiff. These two factors are important in plaintiff's favor.

'Essential to the creation of a debtor-creditor relationship is the existence of a reasonable expectation of repayment at the time of the transaction.' Irbco Corp. v. Commissioner, 25 CCH Tax Ct. Mem. 359, 366 (1966); accord Earle v. W. J. Jones & Son, supra, n. 22. Mr. Sam Fleming, President of the Third National Bank in Nashville, a bank which participated in the loan to Brown-Forman, testified that '* * * barring some unforeseen event, like prohibition or depression, * * * they (New Jack Daniel) should be able to pay the $3.5 million loan.' And, when it was negotiating for its $19.6 million loan, Brown-Forman prepared sales projections for New Jack Daniel to support the probability of its ability to repay Brown-Forman on time. As it turned out, the projections were conservative when compared with New Jack Daniel's actual sales for the years involved. Finally, the reasonableness of the expectation of repayment was verified by the fact that the loan was repaid in 1963 with interest. In Irbco Corp., supra, at 366, the Tax Court, in emphasizing the fact of actual repayment in determining that a bona fide loan existed, said:

> Respondent belittles the significance of the repayments made by Irby & Co. He states that even substantial repayment 'doesn't control' as a reflection of what the parties intended when the loan was made, citing (cases). All of these cases involved repayments, but in none was there a substantial repayment at a time when no further advances were being made. Furthermore, the factual complexions of (the cases cited) are unlike that here present. Two involved advances to new businesses with unproven earning ability. In the other, the borrower had no income in several of the years during which advances were made. These factors

overcame the importance of repayments.

The Government argues that the likelihood of ultimate repayment is, as explained in Affiliated Research, supra, at 342, 351 F.2d at 648, of much less importance than the question of whether repayment is dependent upon the success of the recipient corporation. Even if this is so, and it is so only with the qualification stated above, it is only one factor to be considered and although there are cases finding an advance to be an equity investment even though there was a reasonable expectation of repayment, Fellinger v. United States, 363 F.2d 826 (6th Cir., 1966), the other factors in this case outweigh this consideration. We note that in Fellinger, supra, the lenders had not made a substantial equity investment in the borrower. Moreover, the case at bar is distinguishable from Affiliated Research, supra, on two important grounds: first, the corporation there did not have a substantial amount of equity investment in it, and second, and more important, there was no finding there that there was a reasonable expectation of repayment.

We have found (Finding 66) that 'Brown-Forman determined that a capitalization of $2 million would be adequate for plaintiff's needs and that the Old Jack Daniel assets would be sufficient to carry on the distillery business.' Brown-Forman had years of experience in the whiskey business and was well qualified to make this judgment. That its judgment was correct is borne out by the following facts: (1) upon the liquidation of Old Jack Daniel plaintiff acquired ample cash to supply its needs for working capital (the approximate amount of which was, of course, known to Brown-Forman when the purchase negotiations were proceeding), (2) Brown-Forman never had to make further advances to New Jack Daniel for the operation of the distillery business, and (3) New Jack Daniel was able to pay the $3.5 million loan with interest in 1963. 'There is 'no rule which permits the Commissioner (of Internal Revenue) to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt';' Nassau Lens Co., Inc. v. Commissioner of Internal Revenue, 308 F.2d 39, 46 (2d Cir., 1962), the choice is that of the stockholders. Rowan v. United States, 219 F.2d 51, 54 (5th Cir., 1955).

In American Processing and Sales Company v. United States, [FN23] our latest decision in this area (though specifically dealing with a bad debt situation), before looking at the bona fide nature of the debt in question, we first asked whether the purpose of incorporating the borrower was to perpetrate a tax hoax. Here, as well as there, there were valid business reasons for setting up a new corporation. In the instant case, the Old Jack Daniel stockholders refused to sell the company's assets directly to Brown-Forman. They wanted their former assets and business to be the security for the purchase money notes. The way this desire was fulfilled was by having Brown- Forman set up a new subsidiary to buy the Old Jack Daniel stock, with the subsidiary's stock acting as security for the notes given by it in part- purchase of the old company's stock. In addition, Brown-Forman wished to maintain the local identity of the Jack Daniel business to forestall any adverse public reaction to a change in the control of the business. This was done by incorporating New Jack Daniel as a Tennessee corporation with the same name as Old Jack Daniel, by having New Jack Daniel employ the same officers and personnel as Old Jack Daniel, and by never mentioning Brown-Forman's name in Jack Daniel advertising. It was crucial to the assurance of the continued right to distill Jack Daniel whiskey in Moore County, Tennessee, that the Tennessee identity of the distiller be preserved.

The Government also argues that the burden was on the plaintiff to show that it could have borrowed the $3.5 million from an unrelated source and on the same terms as those actually granted. It is true that the courts have considered this factor in the past. Matthiessen v. Commissioner of Internal Revenue, 16 T.C. 781 (1951), aff'd 194 F.2d 659 (2d Cir., 1952). But the mere fact that a loan could not be obtained from an unrelated source does not preclude the existence of a bona fide loan. Brighton Recreations, Inc., supra, at 135; American Processing and Sales Company, supra, n. 23, 371 F.2d at 852. In Brighton, supra, the corporation

involved was actually unable to secure loans from outside sources, yet countervailing circumstances enable the court to find the existence of a bona fide debt. The case at hand is much stronger (for the taxpayer's position) than those cited for when Brown-Forman borrowed the $19.6 million from its usual banking sources the latter obviously knew and took into account the fact that $3.5 million of that sum was going to be lent by Brown-Forman to New Jack Daniel. In addition, the Third National Bank of Nashville, after having lent Brown- Forman $792,000, lent an additional $300,000 to New Jack Daniel, taking in return its unsecured note. [FN24] See Jaeger Auto Finance, supra, n. 17.

The most important factor, in our minds, leading to a decision for the plaintiff, is the obvious awareness of Brown-Forman's bankers that $3.5 million of their loan to Brown-Forman was going to be passed on to the plaintiff. In substance, the bankers loaned $3.5 million to Brown-Forman in reliance on the fact that while Brown-Forman was going to lend that sum to the plaintiff, it had been satisfactorily established that plaintiff was going to be able to repay that sum in 1963. The bankers were most concerned with Brown-Forman having both a debt and equity position in plaintiff. Had that position been solely equity, as the Government contends it was, Brown-Forman's chance of getting repayment of its advance in case of plaintiff's insolvency would be much less than if it also had a creditor standing. Knowing that the $3.5 million was a loan certainly influenced the bankers' decision in estimating the probability of repayment. This situation is very similar to that in Oak Motors, supra, where the Tax Court stated (at p. 524) in allowing the corporate taxpayer an interest deduction on the stockholder's loan:

> For this purpose, (the stockholder Boyte) was a mere conduit and nothing else. The evidence shows that the Third National Bank * * * considered Boyte's advance--and the note which represented it--to be a bona fide debt of petitioner. This is corroborated by the fact that the bank clearly was relying on repayment of petitioner's indebtedness to Boyte to enable Boyte to repay his own loan, in the same amount, to the bank. [FN25]

So here, the banks were relying upon repayment of New Jack Daniel's debt to Brown-Forman to enable Brown-Forman to fully meet its loan obligation. Brown- Forman needed timely repayment from New Jack Daniel in order to pay its $9.65 million loan. In this situation, to call the advance made to New Jack Daniel one of equity capital would be to ignore the 'substance' of the transaction. Irbco Corp., supra, at 366; Miller's Estate v. Commissioner of Internal Revenue, 239 F.2d 729, 732--733 (9th Cir., 1956).

Accordingly, the plaintiff is entitled to recover on its petition and the defendant is not entitled to recover on its counterclaim. Judgment is therefore entered for plaintiff.

Since the decision in this case has been limited to the issues of law and fact relating to the right of each party to recover, the amounts of recovery, relying upon our decision herein, will be determined pursuant to Rule 47 (c)(2) of the Rules of this court.

Footnotes:

FN* This case was referred to Trial Commissioner Roald Hogenson, with directions to make findings of fact and recommendation for conclusions of law. The Commissioner has done so in an opinion and report filed April 28, 1966. Exceptions were filed by the plaintiff to the commissioner's second recommended conclusion of law in regard to the defendant's counterclaim and by the defendant to the commissioner's first recommended conclusion of law. The court is in agreement with the findings of the commissioner as to both issues. We have adopted his recommended opinion except in regard to the defendant's counterclaim.

FN1. Net fair market value is fair market value less any specific mortgage or pledge to which it is subject. Treas.Reg. § 1.334-- 1(c)(4)(viii), supra. None of the assets in question was subject to a mortgage or pledge. Therefore, fair market value and net fair market value are the same for the purposes of this case.

FN2. The defendant has accepted plaintiff's valuations of all assets other than the three in dispute. Therefore, even if the valuations in dispute are resolved in defendant's favor, plaintiff is entitled to a refund as to the assets no longer in dispute, subject to the decision on defendant's counterclaim.

FN3. Defendant's valuation in a larger amount than allowed by Internal Revenue as the fair market value of the unbottled inventory is another reason why plaintiff would be entitled to a refund, even if defendant's present valuation prevails.

FN4. See generally, 10 Mertens, Federal Income Taxation, § 59.01. (Zimet rev., 1964).

FN5. Defendant has attacked the negotiations between Old Jack Daniel and Brown-Forman as being either nonexistent or solely a sham for tax purposes. The trial commissioner viewed and appraised the witnesses and concluded that the negotiations took place as described in the findings. Defendant argues that because tax considerations were important to the parties and both parties had an incentive to overstate inventory value (for Old Jack Daniel stockholders, in order to secure a high sales price for the shares of stock and insure payment; for Brown-Forman, in order to get a higher basis), the valuation negotiations were necessarily solely tax- oriented. Of course, that conclusion does not necessarily follow from the above premises, and the trial commissioner has concluded that the parties to the sale concluded in good faith that the insurance value was the fair market value of the unbottled whiskey inventory.

FN6. Although defendant has couched its argument in terms of use of the label, presumably the same argument would be presented if a purchaser used the Jack Daniel name without the Jack Daniel label. The inventory could have had three different values, depending upon whether the purchaser used (in descending order of value) the Jack Daniel label, the Jack Daniel name, or the term 'Tennessee Whiskey.' (It is assumed that a bulk purchaser could not be prevented from using the latter term.) As will be developed more fully later plaintiff has presented evidence only as to the highest possible value, and defendant has presented no evidence on any of such values.

FN7. See generally, Paton, Accountants' Handbook, 517 (3d ed. 1947).

FN8. Gordon, What is Fair Market Value?, 8 Tax L.Rev. 35, 36 (1952).

FN9. This conclusion is reinforced by defendant's acceptance of plaintiff's valuation for the bottled inventory. Defendant's rationale that plaintiff's valuation is arbitrary because it includes 100 percent of the profit on the bottle-ripe whiskey applies equally to the bottled whiskey and the unbottled bottle-ripe whiskey.

FN10. The $20 million figure should be $18 million. The stock was purchased for $18 million, which price reflects the value of assets less liabilities. The later liquidation of Old Jack Daniel and assumption of its liabilities by plaintiff did not add anything to the purchase price.

FN11. The Court of Appeals stated in a footnote that a similar problem arose in the valuation of the partnership inventory. It did not specifically state so, but it is clear that similar problems would only arise as to the unfinished portion of the inventory, i.e., the cut but unmilled timber, and would not be factors affecting the value of the finished lumber.

FN12. Plaintiff objected to Brown's testimony on the ground that he was not qualified to give an expert appraisal of whiskey inventory value. Defendant's method of developing its valuation was such that it did not require longstanding and intimate knowledge of the whiskey industry. Therefore, such expertise (or lack thereof) is not the deciding factor in considering Brown's testimony. The deciding factor is the inherent validity (or lack thereof) of defendant's theory of valuation, and Brown's testimony must, of necessity, be considered in this light.

FN13. The contract between Brown-Forman and Young's Market gave Young's Market the right to buy a certain amount of bottle-ripe Early Times under the terms of the barrel purchase contract. However, Early Times was not considered an irreplaceable whiskey.

FN14. In oral argument Defendant's able counsel justly called this issue 'peanuts' because the classification of the amounts accrued by plaintiff as interest or dividends does not result in there being a great difference in the ultimate tax liability. The reason for this is that the Internal Revenue Code (26 U.S.C. § 243) would grant a parent a deduction for 85 percent of the 'dividends' it received from a domestic subsidiary, whereas if it was 'interest' the subsidiary would be able to deduct the full amount (26 U.S.C. § 163) and its parent would have to include the full amount in its income (26 U.S.C. § 61). Though in this latter case the parent would lose its dividends received deduction, the two corporations would be better off as a unit. In this case the net saving would be 7.5 percent on each dollar paid by the subsidiary to its parent as interest, i.e., 50 percent of 15 percent (the increased 100 per cent deduction made available by Section 243(b) of the Internal Revenue Code of 1954 is only available in tax years ending after 12/31/63). This counterclaim was first tendered as an issue by the Government after the 'loan' had been repaid, after the commencement of this suit solely on the issue of fair market value, and after plaintiff's (and Brown-Forman's) tax returns passed audit for seven years.

FN15. 'The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income.' 4A Mertens, Federal Income Taxation, Section 26.10 (revised, 1966).

FN16. 'The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.' United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943). The creditor '* * * seeks a definite obligation, payable in any event.' Commissioner of Internal Revenue v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir., 1942).

FN17. The substance, not the form, of the advances will determine whether they are to be considered as loans or as capital contributions, Crown Iron Works Co. v. Commissioner of Internal Revenue, 245 F.2d 357, 359 (8th Cir., 1957); Jaeger Auto Finance Co. v. Nelson, 191 F.Supp. 693, 697 (D.C.E.D.Wis., 1961); Gilbert v. Commissioner of Internal Revenue, 262 F.2d 512, 513 (2d Cir., 1959), cert. den. 359 U.S. 1002, 79 S.Ct. 1139, 3 L.Ed.2d 1030 (1959).

FN18. The tests the courts have used in this area have been commented upon in great detail. See Goldstein, Corporate Indebtedness to Shareholders: 'Thin Capitalization' and Related Problems, 16 Tax L.Rev. 1 (1960--61); 4A Mertens, supra, n. 15, sections 26.10A--10C and cases cited therein. It is interesting to note that in Mr. Goldstein's opinion, 'Section 163 (of the Internal Revenue Code of 1954) should * * * be amended to disallow the interest deduction to a corporation on any indebtedness held by a corporation which owns 80 percent of the value of its stock.' Goldstein, supra, at 76. This, however, has not been done to date.

FN19. 'Debt is still debt despite subordination.' Kraft Foods Co., supra, at 232 F.2d 125--126; also see John Wanamaker Philadelphia v. Commissioner of Internal Revenue, 139 F.2d 644, 647 (3rd Cir., 1943), ('* * * the most significant characteristic of a creditor-debtor relationship (is) the right to share with general creditors in the assets in the event of dissolution or liquidation * * *.'). Here we have what can be described as an involuntary subordination. The only way the purchase of Old Jack Daniel could be made was to have the New Jack Daniel stock act as security for the purchase money notes, with the note running from New Jack Daniel to Brown-Forman being subordinated to them.

FN20. Also see Kraft Foods Co., supra, at 232 F.2d 125; Royalty Service Corp. v. United States, 178 F.Supp. 216, 220 (D.Mont.1959) (the absence of subordination is a strong factor in the taxpayer's favor); Commissioner of Internal Revenue v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935) (subordination is not fatal).

FN21. '* * * Congress evidently meant the significant factor to be whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business * * *.' Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399, 406 (2d Cir., 1957); Gilbert v. Commissioner of Internal Revenue, supra, n. 17.

FN22. Earle v. W. J. Jones & Son, 200 F.2d 846, 851 (9th Cir., 1952).

FN23. Ct.Cl., January 20, 1967, 371 F.2d 842 (1967).

FN24. The record did not establish that New Jack Daniel would or would not have been able to borrow $3.5 million from an unrelated lender on the same terms as those granted by Brown-Forman. We have found (Finding 74) that '(n)o consideration was given to the possibility of having plaintiff borrow a portion of the required $5.5 million from someone other than Brown-Forman, because Brown-Forman's bankers wanted all of the outside debt consolidated in the Brown-Forman debt structure with them.' This finding justifies giving little weight, if any, to the outside source factor. (Emphasis supplied.)

FN25. It is to be noted that the note given by the corporation to Boyte was subordinated to the rights of all of the corporation's other creditors. Oak Motors, supra, at 522.

(Cite as: 256 F.2d 217)

1 A.F.T.R.2d 834, 58-1 USTC P 9252

United States Court of Appeals Ninth Circuit.

In re ESTATE OF Grace N. WILLIAMS, Deceased.

Ralph E. WILLIAMS, Executor, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

No. 15503.

Jan. 28, 1958.

Petition to review a decision of the Tax Court of the United States. The United States Court of Appeals, James Alger Fee, Circuit Judge, held that determination of the Tax Court that a growing crop of hops on July 31, 1952, at which date taxpayer acquired it as a liquidating dividend was of the fair market value of $11,500 was not clearly wrong.

Affirmed.

West Headnotes

[1] Evidence k113(1)

157k113(1)

"Fair market value" means the price at which a willing buyer and a willing seller would arrive after

negotiation for sale where neither is acting under compulsion.

[2] Internal Revenue k4533

220k4533

(Formerly 220k1290)

Where a hop farm was operated by taxpayer as sole proprietor to March 1, 1951, when its assets and liabilities were transferred to a corporation in exchange for all capital stock thereof, and the corporation was dissolved by vote of taxpayer on July 31, 1952, and farming operations were carried on thereafter by the taxpayer as a sole proprietorship, taxpayer by dissolution of the corporation on July 31 fixed the date as of which the market value of the growing crop of hops, acquired by taxpayer as a liquidating dividend, must be assessed. 26 U.S.C.A. (I.R.C.1939) § 111 (a), (b).

[3] Evidence k574

157k574

The Tax Court is not bound by the uncontradicted testimony of experts and may disregard it altogether in the decision, since expert opinion generally is only a guide to the court where in accordance with the proven facts of the record and where it bears indicia of reliability.

[4] Evidence k571(7)

157k571(7)

In determining the value of a growing crop of hops on the date taxpayer acquired it as a liquidating dividend, Tax Court was not bound by the testimony of expert witnesses as to the value of the crop based upon their estimate of the fair market value upon the thesis that a grower would not sell on a certain date at a price less than the cost of production where such factor did not settle the price that a willing buyer would offer. 26 U.S.C.A. (I.R.C.1939) § 111(a), (b).

[5] Internal Revenue k4660.1

220k4660.1

(Formerly 220k4660, 220k1565)

Where the Hop Control Board set up under the Agricultural Marketing Agreement Act determined the probable salable quantity of the hop crop of 1952 and such formed the basis of a recommendation to the Secretary of Agriculture, who generally adopted it, in determining the salable quantity of hops, fact that Tax Court, in determining that a growing crop of hops on July 31, 1952, at which date taxpayer acquired it as a liquidating dividend, was of the fair market value of a certain sum, considered effect such a pronouncement

by brewers, growers and dealers on the Board before the critical date would have on a buyer willing to but not compelled to buy as of that date was not improper. 26 U.S.C.A. (I.R.C.1939) § 111(a), (b); Agricultural Marketing Agreement Act of 1937, § 1 et seq. as amended by Agricultural Adjustment Act, 7 U.S.C.A. § 601 et seq.

[6] Internal Revenue k4749

220k4749

(Formerly 220k1691)

Where Tax Court determined that a growing crop of hops on July 31, 1952, at which date taxpayer acquired it as a liquidating dividend, was of the fair market value of a certain sum, the fixing of such valuation was a question of fact and the judgment of the Tax Court was almost absolute, though the appellate court would not sustain its findings if, on the record as a whole, there were elements of predetermination, arbitrary exercise of power, or disregard of essential elements. 26 U.S.C.A. (I.R.C.1939) § 111(a), (b).

[7] Internal Revenue k4749

220k4749

(Formerly 220k1691)

Determination of the Tax Court that a growing crop of hops on July 31, 1952, at which date taxpayer acquired it as a liquidating dividend, was of the fair market value of $11,500 was not clearly wrong though the appellate court if deciding the question of fact initially might have arrived at a different figure. 26 U.S.C.A. (I.R.C.1939) § 111(a), (b).

*218 John L. Flynn, Burton L. Coan, Portland, Or., for petitioner.

Charles K. Rice, Asst. Atty. Gen., Arthur I. Gould, John N. Stull, Robert N. Anderson, Charles B. E. Freeman, Attys., Dept. of Justice, Washington, D.C., for respondent.

Before HEALY, FEE and HAMLEY, Circuit Judges.

JAMES ALGER FEE, Circuit Judge.

The Tax Court determined that a growing crop of hops on July 31, 1952, at which date taxpayer acquired it as a liquidating dividend, was of the fair market value of $11,500.00. I.R.C.1939, sec. 111(a, b), 26 U.S.C.A. § 111(a, b). Timely petition for review of the decision was filed in this Court.

The Eola Hop Farms were operated by Grace N. Williams, since deceased, as sole proprietor from some date in 1950 to March 1, 1951, when the assets and liabilities were transferred to Eola Hop Farms, Inc., a corporation, in exchange for all the capital stock thereof. This corporation operated from the last date until

July 31, 1952, when it was dissolved by vote of stock of decedent. Thereafter, farming operations were carried on by decedent as a sole proprietorship. The growing crop of hops was transferred to decedent while not matured, but for all practical purposes no risk of loss by mildew or other crop diseases existed. Decedent operated through the harvest and sale of the crop. In 1953, the hop vines were pulled up and hop growing abandoned. The growing of hops had been less and less profitable since 1950, owing largely to the allocations of salable percentages by the Secretary of Agriculture. After 1953, owing to throwing open the market and foreign competition, it ceased to produce anything but losses.

[1] The concept of fair market value controls the computation of the value of the growing crop. By definition, fair market value means the price at which a willing buyer and a willing seller would arrive, after negotiation for sale, where neither is acting under compulsion. [FN1]

First, it is argued that the Tax Court committed fundamental error because the record shows that decedent would not have sold at a price less than the cost of production on July 31, 1952. At best, that argument is one-sided, as it does not take account of the price a willing buyer *219 would pay on that date, considering all the circumstances. It is noteworthy that decedent set that date by dissolution of the corporation.

The period was not established by the government or the Commissioner. If decedent had desired to take a chance upon the computation of fair market value at a later date, the dissolution could have been withheld. On the other hand, the crop might have been sold before liquidated. This was her voluntary act.

The tax consequences were held in mind. It is apparent that the decedent, as a taxpayer, was aware prior to the liquidation of Eola Farms, Inc., that she could have obtained the total of the investment of the corporation on July 31, 1952, as a deduction from ordinary income by means of a tax free liquidation. I.R.C., 1939, sec. 112(b)(7), 26 U.S.C.A. § 112(b)(7).

[2] The sole purpose of this discussion is to indicate that decedent, by dissolution of the corporation on July 31, fixed the date as of which the fair market value must be assessed. Another time could have been chosen when the market price would have been higher or lower. The same elements control and the same tests must be used, whatever date is used. However, there are problems of great intricacy propounded in fixing the market price of a crop in an intermediate state of growth. Decedent is responsible for the choice of date. The record must be examined to discover whether the Tax Court has made any material error in the process of determining fair market value as of the chosen date and whether there is substantial evidence supporting the figure used by the Tax Court in the final computation.

There is uncontroverted evidence in the record that there was a market price established for the growing hops, but that decedent and petitioner, on her behalf, would not accept it because it was too low. However, the event proved that it was not too low because decedent actually sold in the fall at much less than she had expected. [FN2] Disregarding the latter factor, it is plain that decedent rejected the going market price before the date of liquidation. By deciding to liquidate on July 31, 1952, she determined to accept the fair market price as of that date.

[3][4] Next, petitioner claims that the Tax Court was bound by the testimony of experts, who were uncontradicted. This is not the law. The trier of fact is not bound by expert opinion, and may disregard it altogether in decision. It is true that such a course may be arbitrary and capricious and in opposition to the facts in the record proven by direct evidence. Where this is true, an appellate court may reverse. But generally expert opinion is only a guide to the court, where in accordance with the proven facts of the record

and where it bears indicia of reliability. [FN3] Here the expert witnesses based their estimate of fair market price upon their thesis that a grower would not sell on July 31 at a price less than the cost of production. This does not settle the price a willing buyer would offer, as above noted.

The chief contention, inferentially, of petitioner is that the Tax Court did not know anything about the hop business and was therefore incompetent to pass upon the questions involved. However, judges are often called upon to decide contests which involve solution of highly *220 technical fields of which they possess no expert knowledge or experience.

Petitioner lays great stress upon one feature, which justly might be given great weight against his position. Prior to the time of liquidation chosen by decedent, the Hop Control Board, set up under the Agriculture Market Agreement Act of 1937, 7 U.S.C.A. § 601 et seq., determined the probable salable quantity of the crop of 1952. The figure formed the basis of their recommendation to the Secretary of Agriculture. It was the general practice of the Secretary to adopt this recommendation in determining the salable quantity and, after harvest, to express the quantity as the salable percentage of the crop of each grower. Petitioner and decedent must have known that, upon the basis of this prediction and the estimated size of the crop, [FN4] approximately thirty-five per cent of the crop for that year would probably not be salable.

[5] In accordance with this prediction and recommendation, the Secretary of Agriculture some five months later did adopt a percentage figure in accordance with the prediction as the limitation on the quantity which any grower in the area could sell. Petitioner says the Tax Court erred in assuming that the individual quota had been fixed irrevocably by the Board. That court made no such hypothesis. Indirectly, the Tax Court must have considered the effect of such a pronouncement by brewers, growers and dealers on the board before the critical date would have on the mind of a buyer who was willing to buy but not compelled to buy as of that date. This was not error, but an intelligent use of the legal formula.

[6] The fixing of valuation or fair market value of commodities generally is a most distinctive question of fact. [FN5] Particularly is this true of the fair market value of a growing crop. There the judgment of the trier of fact is almost absolute. It is true the appellate courts will not sustain the findings, if on the record as a whole there are elements of predetermination, arbitrary exercise of power or disregard of essential elements.

[7] Here the Tax Court, according to the opinion and transcript of trial, considered the state of maturity of the crop, the possibility of loss from mildew and disease, the yield estimated from the most accurate sources, the market price of similar hops at the time and the prospect of price in the future, the cost of harvesting, the probable salable quantity based upon the forecast by the committee under the industry agreement, the special knowledge of buyers in the industry and the expert testimony offered. Of course, these factors could not be used mathematically to produce a result. The judgment of the fact finder also entered therein.

The determination cannot therefore be said to be wrong by this Court. Perhaps, had the judges of this Court been deciding the question of fact initially, we might have arrived at a different figure. But we are not empowered to reverse upon that ground.

Affirmed.

FN1. See Elmhurst Cemetery Co. of Joliet v. Commissioner, 300 U.S. 37, 39, 57 S.Ct. 324, 81 L. Ed. 491; A. & A. Tool & Supply Co. v. Commissioner, 10 Cir., 182 F.2d 300, 303; Tracy v.

Commissioner, 6 Cir., 53 F.2d 575, 577.

FN2. The Tax Court found as fact that the average market price of the type of hops here involved was 49 to 52 cents per pound as of July 31, 1952, 30 to 35 cents per pound in the latter part of August, 45 to 50 cents per pound from the middle of October through November, and 50 to 53 cents per pound during December. Petitioner testified that the hops in question were sold 'during the months of from October through December.'

FN3. See Bank of California, National Association v. Commissioner, 9 Cir., 133 F.2d 428, 432; Fitts v. Commissioner, 8 Cir., 237 F.2d 729, 732; Gloyd v. Commissioner, 8 Cir., 63 F.2d 649, 650, certiorari denied, 290 U.S. 633, 54 S.Ct. 52, 78 L.Ed. 551; Tracy v. Commissioner, 6 Cir., 53 F.2d 575, 577.

FN4. There was testimony that beginning July 1, 1952, the Crop Reporting Service made monthly estimates of total crop production.

FN5. See Penn v. Commissioner, 9 Cir., 219 F.2d 18, 20; Hamburger v. Commissioner, 9 Cir., 166 F.2d 422, 425.

END OF DOCUMENT

Sec. 1016. - Adjustments to basis

(a) General rule

Proper adjustment in respect of the property shall in all cases be made -

(1)

for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made -

(A)

for taxes or other carrying charges described in section 266, or

(B)

for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2)

in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount -

(A)

allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B)

resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under the straight line method. Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020 (as in effect before the date of the enactment of the Tax Reform Act of 1976). Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3)

in respect of any period -

(A)

before March 1, 1913,

(B)

since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

(C)

since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply, and

(D)

since February 28, 1913, during which such property was held by a person subject to tax under part II [1] of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply, for exhaustion, wear

and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4)

in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5)

in the case of any bond (as defined in section 171(d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171(a)(2), and in the case of any other bond (as defined in section 171(d)) to the extent of the deductions allowable pursuant to section 171(a)(1) (or the amount applied to reduce interest payments under section 171(e)(2)) with respect thereto;

(6)

in the case of any municipal bond (as defined in section 75(b)), to the extent provided in section 75(a)

(7)

in the case of a residence the acquisition of which resulted, under section 1034 (as in effect on the day before the date of the enactment of the Taxpayer Relief Act of 1997), in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034(e) (as so in effect);

(8)

in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9)

for amounts allowed as deductions as deferred expenses under section 616(b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(10)

Repealed. Pub. L. 94-455, title XIX, Sec. 1901(b)(21)(G), Oct. 4, 1976, 90 Stat. 1798.)

(11)

for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12)

to the extent provided in section 28(h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

(13)

to the extent provided in section 551(e) in the case of the stock of United States shareholders in a foreign personal holding company;

(14)

for amounts allowed as deductions as deferred expenses under section 174(b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15)

for deductions to the extent disallowed under section 272 (relating to disposal of coal or domestic iron ore), notwithstanding the provisions of any other paragraph of this subsection;

(16)

in the case of any evidence of indebtedness referred to in section 811(b) (relating to amortization of premium and accrual of discount in the case of life insurance

companies), to the extent of the adjustments required under section 811(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;

(17)

to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;

(18)

to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock;

(19)

to the extent provided in section 50(c), in the case of expenditures with respect to which a credit has been allowed under section 38;

(20)

for amounts allowed as deductions under section 59 (e) (relating to optional 10-year writeoff of certain tax preferences);

(21)

to the extent provided in section 1059 (relating to reduction in basis for extraordinary dividends);

(22)

in the case of qualified replacement property the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale or exchange of any property, to the extent provided in section 1042(d), [2]

(23)

in the case of property the acquisition of which resulted under section 1043, 1044, 1045, or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, to the extent provided in section 1043 (c), 1044(d), 1045(b)(4), or 1397B(b)(4), as the case may be, [2]

(24)

to the extent provided in section 179A(e)(6)(A), (FOOTNOTE 2)

(25)

to the extent provided in section 30(d)(1), [2]

(26)

to the extent provided in sections 23(g) and 137(e),

(27)

in the case of a residence with respect to which a credit was allowed under section 1400C, to the extent provided in section 1400C(h).

(b) Substituted basis

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in subsection (a) shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

(c) Increase in basis of property on which additional estate tax is imposed

(1) Tax imposed with respect to entire interest

If an additional estate tax is imposed under section 2032A(c)(1) with respect to any interest in property and the qualified heir makes an election under this subsection with respect to the imposition of such tax, the adjusted basis of such interest shall be increased by an amount equal to the excess of -

(A)

the fair market value of such interest on the date of the decedent's death (or the alternate valuation date under section 2032, if the executor of the decedent's estate elected the application of such section), over

(B)

the value of such interest determined under section 2032A(a).

(2) Partial dispositions

(A) In general

In the case of any partial disposition for which an election under this subsection is made, the increase in basis under paragraph (1) shall be an amount -

(i)

which bears the same ratio to the increase which would be determined under paragraph (1) (without regard to this paragraph) with respect to the entire interest, as

(ii)

the amount of the tax imposed under section 2032A(c)(1) with respect to such disposition bears to the adjusted tax difference attributable to the entire interest (as determined under section 2032A (c)(2)(B)).

(B) Partial disposition

For purposes of subparagraph (A), the term ''partial disposition'' means any disposition or cessation to which subsection (c)(2)(D), (h)(1)(B), or (i)(1)(B) of section 2032A applies.

(3) Time adjustment made

Any increase in basis under this subsection shall be deemed to have occurred immediately before the disposition or cessation resulting in the imposition of the tax under section 2032A(c)(1).

(4) Special rule in the case of substituted property

If the tax under section 2032A(c)(1) is imposed with respect to qualified replacement property (as defined in section 2032A(h)(3)(B)) or qualified exchange property (as defined in section 2032A(i)(3)), the increase in basis under paragraph (1) shall be made by reference to the property involuntarily converted or exchanged (as the case may be).

(5) Election

(A) In general

An election under this subsection shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Such an election, once made,

shall be irrevocable.

(B) Interest on recaptured amount

If an election is made under this subsection with respect to any additional estate tax imposed under section 2032A(c)(1), for purposes of section 6601 (relating to interest on underpayments), the last date prescribed for payment of such tax shall be deemed to be the last date prescribed for payment of the tax imposed by section 2001 with respect to the estate of the decedent (as determined for purposes of section 6601).

(d) Reduction in basis of automobile on which gas guzzler tax was imposed

If -

(1)

the taxpayer acquires any automobile with respect to which a tax was imposed by section 4064, and

(2)

the use of such automobile by the taxpayer begins not more than 1 year after the date of the first sale for ultimate use of such automobile,

the basis of such automobile shall be reduced by the amount of the tax imposed by section 4064 with respect to such automobile. In the case of importation, if the date of entry or withdrawal from warehouse for consumption is later than the date of the first sale for ultimate use, such later date shall be substituted for the date of such first sale in the preceding sentence.

(e)

Cross reference

For treatment of separate mineral interests as one property, see section 614

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[1] See References in Text note below.

[2] So in original. The comma probably should be a semicolon.

[2] and

Prev | Next

Sec. 6012. - Persons required to make returns of income

(a) General rule

Returns with respect to income taxes under subtitle A shall be made by the following:

(1)

(A)

Every individual having for the taxable year gross income which equals or exceeds the exemption amount, except that a return shall not be required of an individual -

(i)

who is not married (determined by applying section 7703), is not a surviving spouse (as defined in section 2(a)), is not a head of a household (as defined in section 2(b)), and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(ii)

who is a head of a household (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an individual,

(iii)

who is a surviving spouse (as so defined) and for the taxable year has gross income of less than the sum of the exemption amount plus the basic standard deduction applicable to such an

individual, or

(iv)

who is entitled to make a joint return and whose gross income, when combined with the gross income of his spouse, is, for the taxable year, less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, but only if such individual and his spouse, at the close of the taxable year, had the same household as their home.

Clause (iv) shall not apply if for the taxable year such spouse makes a separate return or any other taxpayer is entitled to an exemption for such spouse under section 151(c).

(B)

The amount specified in clause (i), (ii), or (iii) of subparagraph (A) shall be increased by the amount of 1 additional standard deduction (within the meaning of section 63(c)(3)) in the case of an individual entitled to such deduction by reason of section 63(f)(1)(A) (relating to individuals age 65 or more), and the amount specified in clause (iv) of subparagraph (A) shall be increased by the amount of the additional standard deduction for each additional standard deduction to which the individual or his spouse is entitled by reason of section 63(f)(1).

(C)

The exception under subparagraph (A) shall not apply to any individual -

(i)

who is described in section 63(c)(5) and who has -

(I)

income (other than earned income) in excess of the sum of the amount in effect under section 63(c)(5)(A) plus the additional standard deduction (if any) to which the individual is entitled, or

(II)

total gross income in excess of the standard deduction, or

(ii)

for whom the standard deduction is zero under section 63(c)(6).

(D)

For purposes of this subsection -

(i)

The terms ''standard deduction'', ''basic standard deduction'' and ''additional standard deduction'' have the respective meanings given such terms by section 63(c).

(ii)

The term ''exemption amount'' has the meaning given such term by section 151(d). In the case of an individual described in section 151(d)(2), the exemption amount shall be zero.

(2)

Every corporation subject to taxation under subtitle A;

(3)

Every estate the gross income of which for the taxable year is $600 or more;

(4)

Every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income;

(5)

Every estate or trust of which any beneficiary is a nonresident alien;

(6)

Every political organization (within the meaning of section 527(e)(1)), and every fund treated under section 527(g) as if it constituted a political organization, which has political organization taxable income (within the meaning of section 527(c)(1)) for the taxable year or which has gross receipts of $25,000 or more for the taxable year (other than an organization to which section 527 applies solely by reason of subsection (f)(1) of such section); and [1] (FOOTNOTE 1) So in original.

(7)

Every homeowners association (within the meaning of section 528(c)(1)) which has homeowners association taxable income (within the meaning of section 528(d)) for the taxable year.

(8)

Every individual who receives payments during the calendar year in which the taxable year begins under section 3507 (relating to advance payment of earned income credit). (FOOTNOTE 1)

(9)

Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under section 63(c)(2)(D). [1] except that subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary, nonresident alien individuals subject to the tax imposed by section 871 and foreign corporations subject to the tax imposed by section 881 may be exempted from the requirement of making returns under this section.

(b) Returns made by fiduciaries and receivers

(1) Returns of decedents

If an individual is deceased, the return of such individual required under subsection (a) shall be made by his executor, administrator, or other person charged with the property of such decedent.

(2) Persons under a disability

If an individual is unable to make a return required under subsection (a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.

(3) Receivers, trustees and assignees for corporations

In a case where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law

or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

(4) Returns of estates and trusts

Returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

(5) Joint fiduciaries

Under such regulations as the Secretary may prescribe, a return made by one of two or more joint fiduciaries shall be sufficient compliance with the requirements of this section. A return made pursuant to this paragraph shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(6) IRA share of partnership income

In the case of a trust which is exempt from taxation under section 408(e), for purposes of this section, the trust's distributive share of items of gross income and gain of any partnership to which subchapter C or D of chapter 63 applies shall be treated as equal to the trust's distributive share of the taxable income of such partnership.

(c) Certain income earned abroad or from sale of residence

For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 121 (relating to gain from sale of principal residence) and without regard to the exclusion provided for in section 911 (relating to citizens or residents of the United States living abroad).

(d) Tax-exempt interest required to be shown on return

Every person required to file a return under this section for the taxable year shall include on such return the amount of interest received or accrued during the taxable year which is exempt from the tax imposed by chapter 1.

(e)

Consolidated returns

For provisions relating to consolidated returns by affiliated corporations, see chapter 6

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[1]

Next

§ 6017. Self-employment tax returns

Every individual (other than a nonresident alien individual) having net earnings from self-employment of $400 or more for the taxable year shall make a return with respect to the self-employment tax imposed by chapter 2. In the case of a husband and wife filing a joint return under section 6013, the tax imposed by chapter 2 shall not be computed on the aggregate income but shall be the sum of the taxes computed under such chapter on the separate self-employment income of each spouse.

Sec. 6017. - Self-employment tax returns

Every individual (other than a nonresident alien individual) having net earnings from self-employment of $400 or more for the taxable year shall make a return with respect to the self-employment tax imposed by chapter 2. In the case of a husband and wife filing a joint return under section 6013, the tax imposed by chapter 2 shall not be computed on the aggregate income but shall be the sum of the taxes computed under such chapter on the separate self-employment income of each spouse

§ 1402. Definitions

(a) Net earnings from self-employment

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if

(A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and

(B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;

(2) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities;

(3) there shall be excluded any gain or loss—

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither—

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) property held primarily for sale to customers in the ordinary course of the trade or business;

(4) the deduction for net operating losses provided in section 172 shall not be allowed;

(5) if—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the spouse carrying on such trade or business or, if such trade or business is jointly operated, treated as the gross income and deductions of each spouse on the basis of their respective distributive share of the gross income and deductions; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(6) a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(7) the deduction for personal exemptions provided in section 151 shall not be allowed;

(8) an individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order shall compute his net earnings from self-employment derived from the performance of service described in subsection (c)(4) without regard to section 107 (relating to rental value of parsonages), section 119 (relating to meals and lodging furnished for the convenience of the employer), and section 911 (relating to citizens or residents of the United States living abroad), but shall not include in such net earnings from self-employment the rental

value of any parsonage or any parsonage allowance (whether or not excludable under section 107) provided after the individual retires, or any other retirement benefit received by such individual from a church plan (as defined in section 414 (e)) after the individual retires;

(9) the exclusion from gross income provided by section 931 shall not apply;

(10) there shall be excluded amounts received by a partner pursuant to a written plan of the partnership, which meets such requirements as are prescribed by the Secretary, and which provides for payments on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, if—

(A) such partner rendered no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year of such partnership (or its successors), ending within or with his taxable year, in which such amounts were received, and

(B) no obligation exists (as of the close of the partnership's taxable year referred to in subparagraph (A)) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subparagraph (A);

(11) the exclusion from gross income provided by section 911 (a)(1) shall not apply;

(12) in lieu of the deduction provided by section 164 (f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction equal to the product of—

(A) the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph), and

(B) one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year;

(13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707 (c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;

(14) in the case of church employee income, the special rules of subsection (j)(1) shall apply;

(15) in the case of a member of an Indian tribe, the special rules of section 7873 (relating to income derived by Indians from exercise of fishing rights) shall apply, and

(16) the deduction provided by section 199 shall not be allowed.

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year. In the case of any trade or business which is carried on by an individual or by a partnership and in which, if such trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in

section 3121 (g)—

(i) in the case of an individual, if the gross income derived by him from such trade or business is not more than $2,400, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be 662/3 percent of such gross income; or

(ii) in the case of an individual, if the gross income derived by him from such trade or business is more than $2,400 and the net earnings from self-employment derived by him from such trade or business (computed under this subsection without regard to this sentence) are less than $1,600, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be $1,600; and

(iii) in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707 (c) applies) is not more than $2,400, his distributive share of income described in section 702 (a)(8) derived from such trade or business may, at his option, be deemed to be an amount equal to 662/3 percent of his distributive share of such gross income (after such gross income has been so reduced); or

(iv) in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707 (c) applies) is more than $2,400 and his distributive share (whether or not distributed) of income described in section 702 (a)(8) derived from such trade or business (computed under this subsection without regard to this sentence) is less than $1,600, his distributive share of income described in section 702 (a)(8) derived from such trade or business may, at his option, be deemed to be $1,600.

For purposes of the preceding sentence, gross income means—

(v) in the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection; and

(vi) in the case of any such trade or business in which the income is computed under an accrual method, the gross income from such trade or business, adjusted in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection;

and, for purposes of such sentence, if an individual (including a member of a partnership) derives gross income from more than one such trade or business, such gross income (including his distributive share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business.

The preceding sentence and clauses (i) through (iv) of the second preceding sentence shall also apply in the case of any trade or business (other than a trade or business specified in such second preceding sentence) which is carried on by an individual who is self-employed on a regular basis as defined in subsection (h), or by a partnership of which an individual is a member on a regular basis as defined in subsection (h), but only if such individual's net earnings

from self-employment as determined without regard to this sentence in the taxable year are less than $1,600 and less than 662/3 percent of the sum (in such taxable year) of such individual's gross income derived from all trades or businesses carried on by him and his distributive share of the income or loss from all trades or businesses carried on by all the partnerships of which he is a member; except that this sentence shall not apply to more than 5 taxable years in the case of any individual, and in no case in which an individual elects to determine the amount of his net earnings from self-employment for a taxable year under the provisions of the two preceding sentences with respect to a trade or business to which the second preceding sentence applies and with respect to a trade or business to which this sentence applies shall such net earnings for such year exceed $1,600.

(b) Self-employment income

The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual, except as provided by an agreement under section 233 of the Social Security Act) during any taxable year; except that such term shall not include—

(1) in the case of the tax imposed by section 1401 (a), that part of the net earnings from self-employment which is in excess of

(i) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus

(ii) the amount of the wages paid to such individual during such taxable years; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of paragraph (1), the term "wages" (A) includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 3121 (l) (relating to coverage of citizens of the United States who are employees of foreign affiliates of American employers), as would be wages under section 3121 (a) if such services constituted employment under section 3121 (b), and (B) includes compensation which is subject to the tax imposed by section 3201 or 3211,.[1] An individual who is not a citizen of the United States but who is a resident of the Commonwealth of Puerto Rico, the Virgin Islands, Guam, or American Samoa shall not, for purposes of this chapter be considered to be a nonresident alien individual. In the case of church employee income, the special rules of subsection (j)(2) shall apply for purposes of paragraph (2).

(c) Trade or business

The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office, other than the functions of a public office of a State or a political subdivision thereof with respect to fees received in any period in which the functions are performed in a position compensated solely on a fee basis and in which such functions are not covered under an agreement entered into by such

State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act;

(2) the performance of service by an individual as an employee, other than—

(A) service described in section 3121 (b)(14)(B) performed by an individual who has attained the age of 18,

(B) service described in section 3121 (b)(16),

(C) service described in section 3121 (b)(11), (12), or (15) performed in the United States (as defined in section 3121 (e)(2)) by a citizen of the United States, except service which constitutes "employment" under section 3121 (y),

(D) service described in paragraph (4) of this subsection,

(E) service performed by an individual as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis with respect to fees received in any period in which such service is not covered under an agreement entered into by such State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act,

(F) service described in section 3121 (b) (20), and

(G) service described in section 3121 (b)(8)(B);

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order;

(5) the performance of service by an individual in the exercise of his profession as a Christian Science practitioner; or

(6) the performance of service by an individual during the period for which an exemption under subsection (g) is effective with respect to him.

The provisions of paragraph (4) or (5) shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual unless an exemption under subsection (e) is effective with respect to him.

(d) Employee and wages

The term "employee" and the term "wages" shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

(e) Ministers, members of religious orders, and Christian Science practitioners

(1) Exemption

Subject to paragraph (2), any individual who is

(A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or

(B) a Christian Science practitioner, upon filing an application (in such form and manner, and with such official, as may be prescribed by

regulations made under this chapter) together with a statement that either he is conscientiously opposed to, or because of religious principles he is opposed to, the acceptance (with respect to services performed by him as such minister, member, or practitioner) of any public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act) and, in the case of an individual described in subparagraph (A), that he has informed the ordaining, commissioning, or licensing body of the church or order that he is opposed to such insurance, shall receive an exemption from the tax imposed by this chapter with respect to services performed by him as such minister, member, or practitioner. Notwithstanding the preceding sentence, an exemption may not be granted to an individual under this subsection if he had filed an effective waiver certificate under this section as it was in effect before its amendment in 1967.

(2) Verification of application

The Secretary may approve an application for an exemption filed pursuant to paragraph (1) only if the Secretary has verified that the individual applying for the exemption is aware of the grounds on which the individual may receive an exemption pursuant to this subsection and that the individual seeks exemption on such grounds. The Secretary (or the Commissioner of Social Security under an agreement with the Secretary) shall make such verification by such means as prescribed in regulations.

(3) Time for filing application

Any individual who desires to file an application pursuant to paragraph (1) must file such application on or before whichever of the following dates is later:

(A) the due date of the return (including any extension thereof) for the second taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5)) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5); or

(B) the due date of the return (including any extension thereof) for his second taxable year ending after 1967.

(4) Effective date of exemption

An exemption received by an individual pursuant to this subsection shall be effective for the first taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5)) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5), and for all succeeding taxable years. An exemption received pursuant to this subsection shall be irrevocable.

(f) Partner's taxable year ending as the result of death

In computing a partner's net earnings from self-employment for his taxable year which ends as a result of his death (but only if such taxable year ends within, and not with, the taxable year of the partnership), there shall be included so much of the deceased partner's distributive share of the partnership's ordinary income or loss for the partnership taxable year as is not attributable to an interest in the partnership during any period beginning on or after the first day of the first calendar month following the month in which such partner died. For purposes of this subsection—

(1) in determining the portion of the distributive share which is attributable to any period specified in the preceding sentence, the ordinary income or loss of the partnership shall be treated as having been realized or sustained ratably over the partnership taxable year; and

(2) the term "deceased partner's distributive share" includes the share of his estate or of any other person succeeding, by reason of his death, to rights with respect to his partnership interest.

(g) Members of certain religious faiths

(1) Exemption

Any individual may file an application (in such form and manner, and with such official, as may be prescribed by regulations under this chapter) for an exemption from the tax imposed by this chapter if he is a member of a recognized religious sect or division thereof and is an adherent of established tenets or teachings of such sect or division by reason of which he is conscientiously opposed to acceptance of the benefits of any private or public insurance which makes payments in the event of death, disability, old-age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act). Such exemption may be granted only if the application contains or is accompanied by—

(A) such evidence of such individual's membership in, and adherence to the tenets or teachings of, the sect or division thereof as the Secretary may require for purposes of determining such individual's compliance with the preceding sentence, and

(B) his waiver of all benefits and other payments under titles II and XVIII of the Social Security Act on the basis of his wages and self-employment income as well as all such benefits and other payments to him on the basis of the wages and self-employment income of any other person,

and only if the Commissioner of Social Security finds that—

(C) such sect or division thereof has the established tenets or teachings referred to in the preceding sentence,

(D) it is the practice, and has been for a period of time which he deems to be substantial, for members of such sect or division thereof to make provision for their dependent members which in his judgment is reasonable in view of their general level of living, and

(E) such sect or division thereof has been in existence at all times since December 31, 1950.

An exemption may not be granted to any individual if any benefit or other payment referred to in subparagraph (B) became payable (or, but for section 203 or 222(b) of the Social Security Act, would have become payable) at or before the time of the filing of such waiver.

(2) Period for which exemption effective

An exemption granted to any individual pursuant to this subsection shall apply with respect to all taxable years beginning after December 31, 1950, except that such exemption shall not apply for any taxable year—

(A) beginning (i) before the taxable year in which such individual first met the requirements of the first sentence of paragraph (1), or (ii) before the time as of which the Commissioner of Social Security finds that the sect or division thereof of which such individual is a member met the requirements of subparagraphs (C) and (D), or

(B) ending (i) after the time such individual ceases to meet the requirements of the first sentence of paragraph (1), or (ii) after the time as of which the Commissioner of Social Security finds that the sect or division thereof of which he is a member ceases to meet the requirements of subparagraph (C) or (D).

(3) Subsection to apply to certain church employees

This subsection shall apply with respect to services which are described in subparagraph (B) of section 3121 (b)(8) (and are not described in subparagraph (A) of such section).

(h) Regular basis

An individual shall be deemed to be self-employed on a regular basis in a taxable year, or to be a member of a partnership on a regular basis in such year, if he had net earnings from self-employment, as defined in the first sentence of subsection (a), of not less than $400 in at least two of the three consecutive taxable years immediately preceding such taxable year from trades or businesses carried on by such individual or such partnership.

(i) Special rules for options and commodities dealers

(1) In general

Notwithstanding subsection (a)(3)(A), in determining the net earnings from self-employment of any options dealer or commodities dealer, there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts.

(2) Definitions

For purposes of this subsection—

(A) Options dealer

The term "options dealer" has the meaning given such term by section 1256 (g)(8).

(B) Commodities dealer

The term "commodities dealer" means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(C) Section 1256 contracts

The term "section 1256 contract" has the meaning given to such term by section 1256 (b).

(j) Special rules for certain church employee income

(1) Computation of net earnings

In applying subsection (a)—

(A) church employee income shall not be reduced by any deduction;

(B) church employee income and deductions attributable to such income shall not be taken into account in determining the amount of other net earnings from self-employment.

(2) Computation of self-employment income

(A) Separate application of subsection (b)(2)

Paragraph (2) of subsection (b) shall be applied separately—

(i) to church employee income, and

(ii) to other net earnings from self-employment.

(B) $100 floor

In applying paragraph (2) of subsection (b) to church employee income, "$100" shall be substituted for "$400".

(3) Coordination with subsection (a)(12)

Paragraph (1) shall not apply to any amount allowable as a deduction under subsection (a)(12), and paragraph (1) shall be applied before determining the amount so allowable.

(4) Church employee income defined

For purposes of this section, the term "church employee income" means gross income for services which are described in section 3121 (b)(8)(B) (and are not described in section 3121 (b)(8)(A)).

(k) Codification of treatment of certain termination payments received by former insurance salesmen

Nothing in subsection (a) shall be construed as including in the net earnings from self-employment of an individual any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if—

(1) such amount is received after termination of such individual's agreement to perform such services for such company,

(2) such individual performs no services for such company after such termination and before the close of such taxable year,

(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4) the amount of such payment—

(A) depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

(B) does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

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[1] So in original.

Prev | Next

Sec. 1402. - Definitions

(a) Net earnings from self-employment

The term ''net earnings from self-employment'' means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss -

(1)

there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if

(A)

such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and

(B)

there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;

(2)

there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities;

(3)

there shall be excluded any gain or loss -

(A)

which is considered as gain or loss from the sale or exchange of a capital asset,

(B)

from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 applies to such gain or loss, or

(C)

from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither -

(i)

stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii)

property held primarily for sale to customers in the ordinary course of the trade or business;

(4)

the deduction for net operating losses provided in section 172 shall not be allowed;

(5)

if -

(A)

any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B)

any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(6)

a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(7)

the deduction for personal exemptions provided in section 151 shall not be allowed;

(8)

an individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order shall compute his net earnings from self-employment derived from the performance of service described in subsection (c)(4) without regard to section 107 (relating to rental value of parsonages), section 119 (relating to meals and lodging furnished for the convenience of the employer), and section 911 (relating to citizens or residents of the United States living abroad), but shall not include in such net earnings from self-employment the rental value of any parsonage or any

parsonage allowance (whether or not excludable under section 107) provided after the individual retires, or any other retirement benefit received by such individual from a church plan (as defined in section 414 (e)) after the individual retires;

(9)

the exclusion from gross income provided by section 931 shall not apply;

(10)

there shall be excluded amounts received by a partner pursuant to a written plan of the partnership, which meets such requirements as are prescribed by the Secretary, and which provides for payments on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, if -

(A)

such partner rendered no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year of such partnership (or its successors), ending within or with his taxable year, in which such amounts were received, and

(B)

no obligation exists (as of the close of the partnership's taxable year referred to in subparagraph (A)) from the other partners to such partner except with respect to retirement payments under such plan, and

(C)

such partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subparagraph (A);

(11)

the exclusion from gross income provided by section 911(a)(1) shall not apply;

(12)

in lieu of the deduction provided by section 164(f) (relating to deduction for one-half of self-employment

taxes), there shall be allowed a deduction equal to the product of -

(A)

the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph), and

(B)

one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year;

(13)

there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;

(14)

in the case of church employee income, the special rules of subsection (j)(1) shall apply; and

(15)

in the case of a member of an Indian tribe, the special rules of section 7873 (relating to income derived by Indians from exercise of fishing rights) shall apply.

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year. In the case of any trade or business which is carried on by an individual or by a partnership and in which, if such trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) -

(i)

in the case of an individual, if the gross income derived by him from such trade or business is not more than $2,400, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be 66

2/3 percent of such gross income; or

(ii)

in the case of an individual, if the gross income derived by him from such trade or business is more than $2,400 and the net earnings from self-employment derived by him from such trade or business (computed under this subsection without regard to this sentence) are less than $1,600, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be $1,600; and

(iii)

in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is not more than $2,400, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be an amount equal to 66 2/3 percent of his distributive share of such gross income (after such gross income has been so reduced); or

(iv)

in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is more than $2,400 and his distributive share (whether or not distributed) of income described in section 702(a)(8) derived from such trade or business (computed under this subsection without regard to this sentence) is less than $1,600, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be $1,600.

For purposes of the preceding sentence, gross income means -

(v)

in the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from

such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection; and

(vi)

in the case of any such trade or business in which the income is computed under an accrual method, the gross income from such trade or business, adjusted in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection;

and, for purposes of such sentence, if an individual (including a member of a partnership) derives gross income from more than one such trade or business, such gross income (including his distributive share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business.

The preceding sentence and clauses (i) through (iv) of the second preceding sentence shall also apply in the case of any trade or business (other than a trade or business specified in such second preceding sentence) which is carried on by an individual who is self-employed on a regular basis as defined in subsection (h), or by a partnership of which an individual is a member on a regular basis as defined in subsection (h), but only if such individual's net earnings from self-employment as determined without regard to this sentence in the taxable year are less than $1,600 and less than 66 2/3 percent of the sum (in such taxable year) of such individual's gross income derived from all trades or businesses carried on by him and his distributive share of the income or loss from all trades or businesses carried on by all the partnerships of which he is a member; except that this sentence shall not apply to more than 5 taxable years in the case of any individual, and in no case in which an individual elects to determine the amount of his net earnings from self-employment for a taxable year under the provisions of the two preceding sentences with respect to a trade or business to which the second preceding sentence applies and with respect to a trade or business to which this sentence applies shall such net earnings for such year exceed $1,600.

(b) Self-employment income

The term ''self-employment income'' means the net earnings from self-employment derived by an individual (other than a nonresident alien individual, except as provided by an agreement under section 233 of the Social

Security Act) during any taxable year; except that such term shall not include -

(1)

in the case of the tax imposed by section 1401(a), that part of the net earnings from self-employment which is in excess of

(i)

an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus

(ii)

the amount of the wages paid to such individual during such taxable years; or

(2)

the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of paragraph (1), the term ''wages''

(A)

includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 3121(l) (relating to coverage of citizens of the United States who are employees of foreign affiliates of American employers), as would be wages under section 3121(a) if such services constituted employment under section 3121(b), and

(B)

includes compensation which is subject to the tax imposed by section 3201 or 3211,. [1] An individual who is not a citizen of the United States but who is a resident of the Commonwealth of Puerto Rico, the Virgin Islands, Guam, or American Samoa shall not, for purposes of this chapter be considered to be a nonresident alien individual. In the case of church employee income, the special rules of subsection (j) (2) shall apply for purposes of paragraph (2).

(c) Trade or business

The term ''trade or business'', when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include -

(1)

the performance of the functions of a public office, other than the functions of a public office of a State or a political subdivision thereof with respect to fees received in any period in which the functions are performed in a position compensated solely on a fee basis and in which such functions are not covered under an agreement entered into by such State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act;

(2)

the performance of service by an individual as an employee, other than -

(A)

service described in section 3121(b)(14)(B) performed by an individual who has attained the age of 18,

(B)

service described in section 3121(b)(16),

(C)

service described in section 3121(b)(11), (12), or (15) performed in the United States (as defined in section 3121(e)(2)) by a citizen of the United States, except service which constitutes ''employment'' under section 3121(y),

(D)

service described in paragraph (4) of this subsection,

(E)

service performed by an individual as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis with respect to fees received in any period in which such service is not covered under an agreement entered into by such State and the Commissioner of Social

Security pursuant to section 218 of the Social Security Act,

(F)

service described in section 3121(b) (20), and (G) service described in section 3121(b)(8)(B);

(3)

the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4)

the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order;

(5)

the performance of service by an individual in the exercise of his profession as a Christian Science practitioner; or

(6)

the performance of service by an individual during the period for which an exemption under subsection (g) is effective with respect to him.

The provisions of paragraph (4) or (5) shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual unless an exemption under subsection (e) is effective with respect to him.

(d) Employee and wages

The term ''employee'' and the term ''wages'' shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

(e) Ministers, members of religious orders, and Christian Science practitioners

(1) Exemption

Subject to paragraph (2), any individual who is

(A)

a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or

(B)

a Christian Science practitioner, upon filing an application (in such form and manner, and with such official, as may be prescribed by regulations made under this chapter) together with a statement that either he is conscientiously opposed to, or because of religious principles he is opposed to, the acceptance (with respect to services performed by him as such minister, member, or practitioner) of any public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act) and, in the case of an individual described in subparagraph (A), that he has informed the ordaining, commissioning, or licensing body of the church or order that he is opposed to such insurance, shall receive an exemption from the tax imposed by this chapter with respect to services performed by him as such minister, member, or practitioner. Notwithstanding the preceding sentence, an exemption may not be granted to an individual under this subsection if he had filed an effective waiver certificate under this section as it was in effect before its amendment in 1967.

(2) Verification of application

The Secretary may approve an application for an exemption filed pursuant to paragraph (1) only if the Secretary has verified that the individual applying for the exemption is aware of the grounds on which the individual may receive an exemption pursuant to this subsection and that the individual seeks exemption on such grounds. The Secretary (or the Commissioner of Social Security under an agreement with the Secretary) shall make such verification by such means as prescribed in regulations.

(3) Time for filing application

Any individual who desires to file an application pursuant to paragraph (1) must file such application on or before whichever of the following dates is later:

(A)

the due date of the return (including any extension thereof) for the second taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5)) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5); or

(B)

the due date of the return (including any extension thereof) for his second taxable year ending after 1967.

(4) Effective date of exemption

An exemption received by an individual pursuant to this subsection shall be effective for the first taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5)) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5), and for all succeeding taxable years. An exemption received pursuant to this subsection shall be irrevocable.

(f) Partner's taxable year ending as the result of death

In computing a partner's net earnings from self-employment for his taxable year which ends as a result of his death (but only if such taxable year ends within, and not with, the taxable year of the partnership), there shall be included so much of the deceased partner's distributive share of the partnership's ordinary income or loss for the partnership taxable year as is not attributable to an interest in the partnership during any period beginning on or after the first day of the first calendar month following the month in which such partner died. For purposes of this subsection -

(1)

in determining the portion of the distributive share which is attributable to any period specified in the preceding sentence, the ordinary income or loss of the partnership shall be treated as having been realized or sustained ratably over the partnership taxable year; and

(2)

the term ''deceased partner's distributive share'' includes the share of his estate or of any other person succeeding, by reason of his death, to rights with respect

to his partnership interest.

(g) Members of certain religious faiths

(1) Exemption

Any individual may file an application (in such form and manner, and with such official, as may be prescribed by regulations under this chapter) for an exemption from the tax imposed by this chapter if he is a member of a recognized religious sect or division thereof and is an adherent of established tenets or teachings of such sect or division by reason of which he is conscientiously opposed to acceptance of the benefits of any private or public insurance which makes payments in the event of death, disability, old-age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act). Such exemption may be granted only if the application contains or is accompanied by -

(A)

such evidence of such individual's membership in, and adherence to the tenets or teachings of, the sect or division thereof as the Secretary may require for purposes of determining such individual's compliance with the preceding sentence, and

(B)

his waiver of all benefits and other payments under titles II and XVIII of the Social Security Act on the basis of his wages and self-employment income as well as all such benefits and other payments to him on the basis of the wages and self-employment income of any other person,

and only if the Commissioner of Social Security finds that -

(C)

such sect or division thereof has the established tenets or teachings referred to in the preceding sentence,

(D)

it is the practice, and has been for a period of time which he deems to be substantial, for members of such sect or division thereof to make provision for their dependent members which in his judgment is

reasonable in view of their general level of living, and

(E)

such sect or division thereof has been in existence at all times since December 31, 1950.

An exemption may not be granted to any individual if any benefit or other payment referred to in subparagraph (B) became payable (or, but for section 203 or 222(b) of the Social Security Act, would have become payable) at or before the time of the filing of such waiver.

(2) Period for which exemption effective

An exemption granted to any individual pursuant to this subsection shall apply with respect to all taxable years beginning after December 31, 1950, except that such exemption shall not apply for any taxable year -

(A)

beginning

(i)

before the taxable year in which such individual first met the requirements of the first sentence of paragraph (1), or (ii) before the time as of which the Commissioner of Social Security finds that the sect or division thereof of which such individual is a member met the requirements of subparagraphs (C) and (D), or

(B)

ending

(i)

after the time such individual ceases to meet the requirements of the first sentence of paragraph (1), or (ii) after the time as of which the Commissioner of Social Security finds that the sect or division thereof of which he is a member ceases to meet the requirements of subparagraph (C) or (D).

(3) Subsection to apply to certain church employees

This subsection shall apply with respect to services which are described in subparagraph (B) of section 3121 (b)(8) (and are not described in subparagraph (A) of such section).

(h) Regular basis

An individual shall be deemed to be self-employed on a regular basis in a taxable year, or to be a member of a partnership on a regular basis in such year, if he had net earnings from self-employment, as defined in the first sentence of subsection (a), of not less than $400 in at least two of the three consecutive taxable years immediately preceding such taxable year from trades or businesses carried on by such individual or such partnership.

(i) Special rules for options and commodities dealers

(1) In general

Notwithstanding subsection (a)(3)(A), in determining the net earnings from self-employment of any options dealer or commodities dealer, there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts.

(2) Definitions

For purposes of this subsection -

(A) Options dealer

The term ''options dealer'' has the meaning given such term by section 1256(g)(8).

(B) Commodities dealer

The term ''commodities dealer'' means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(C) Section 1256 contracts

The term ''section 1256 contract'' has the meaning given to such term by section 1256(b).

(j) Special rules for certain church employee income

(1) Computation of net earnings

In applying subsection (a) -

(A)

church employee income shall not be reduced by

any deduction;

(B)

church employee income and deductions attributable to such income shall not be taken into account in determining the amount of other net earnings from self-employment.

(2) Computation of self-employment income

(A) Separate application of subsection (b)(2)

Paragraph (2) of subsection (b) shall be applied separately -

(i)

to church employee income, and

(ii)

to other net earnings from self-employment.

(B)

$100 floor

In applying paragraph (2) of subsection (b) to church employee income, ''$100'' shall be substituted for ''$400''.

(3) Coordination with subsection (a)(12)

Paragraph (1) shall not apply to any amount allowable as a deduction under subsection (a)(12), and paragraph (1) shall be applied before determining the amount so allowable.

(4) Church employee income defined

For purposes of this section, the term ''church employee income'' means gross income for services which are described in section 3121(b)(8)(B) (and are not described in section 3121(b)(8)(A)).

(k) Codification of treatment of certain termination payments received by former insurance salesmen

Nothing in subsection (a) shall be construed as including in the net earnings from self-employment of an individual any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if -

(1)

such amount is received after termination of such individual's agreement to perform such services for such company,

(2)

such individual performs no services for such company after such termination and before the close of such taxable year,

(3)

such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4)

the amount of such payment -

(A)

depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

(B)

does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service)

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[1] So in original.

Prev | Next

§ 1. Tax imposed

How Current is This?

(a) Married individuals filing joint returns and surviving spouses

There is hereby imposed on the taxable income of—

(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

(2) every surviving spouse (as defined in section 2 (a)),

a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $36,900	15% of taxable income.
Over $36,900 but not over $89,150	$5,535, plus 28% of the excess over $36,900.
Over $89,150 but not over $140,000	$20,165, plus 31% of the excess over $89,150.
Over $140,000 but not over $250,000	$35,928.50, plus 36% of the excess over $140,000.
Over $250,000	$75,528.50, plus 39.6% of the excess over $250,000.

(b) Heads of households

There is hereby imposed on the taxable income of every head of a household (as defined in section 2 (b)) a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $29,600	15% of taxable income.
Over $29,600 but not over $76,400	$4,440, plus 28% of the excess over $29,600.
Over $76,400 but not over $127,500	$17,544, plus 31% of the excess over $76,400.
Over $127,500 but not over $250,000	$33,385, plus 36% of the excess over $127,500.
Over $250,000	$77,485, plus 39.6% of the excess over $250,000.

(c) Unmarried individuals (other than surviving spouses and heads of households)

There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2 (a) or the head of a household as defined in section 2 (b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $22,100	15% of taxable income.
Over $22,100 but not over $53,500	$3,315, plus 28% of the excess over $22,100.
Over $53,500 but not over $115,000	$12,107, plus 31% of the excess over $53,500.
Over $115,000 but not over $250,000	$31,172, plus 36% of the excess over $115,000.
Over $250,000	$79,772, plus 39.6% of the excess over $250,000.

(d) Married individuals filing separate returns

There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $18,450	15% of taxable income.
Over $18,450 but not over $44,575	$2,767.50, plus 28% of the excess over $18,450.
Over $44,575 but not over $70,000	$10,082.50, plus 31% of the excess over $44,575.
Over $70,000 but not over $125,000	$17,964.25, plus 36% of the excess over $70,000.
Over $125,000	$37,764.25, plus 39.6% of the excess over $125,000.

(e) Estates and trusts

There is hereby imposed on the taxable income of—

(1) every estate, and

(2) every trust,

taxable under this subsection a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $1,500	15% of taxable income.
Over $1,500 but not over $3,500	$225, plus 28% of the excess over $1,500.
Over $3,500 but not over $5,500	$785, plus 31% of the excess over $3,500.
Over $5,500 but not over $7,500	$1,405, plus 36% of the excess over $5,500.
Over $7,500	$2,125, plus 39.6% of the excess over $7,500.

(f) Phaseout of marriage penalty in 15-percent bracket; adjustments in tax tables so that inflation will not result in tax increases

(1) In general

Not later than December 15 of 1993, and each subsequent calendar year, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in subsections (a), (b), (c), (d), and (e) with respect to taxable years beginning in the succeeding calendar year.

(2) Method of prescribing tables

The table which under paragraph (1) is to apply in lieu of the table contained in subsection (a), (b), (c), (d), or (e), as the case may be, with respect to taxable years beginning in any calendar year shall be prescribed—

(A) except as provided in paragraph (8), by increasing the minimum and maximum dollar amounts for each rate bracket for which a tax is imposed under such table by the cost-of-living adjustment for such calendar year,

(B) by not changing the rate applicable to any rate bracket as adjusted under subparagraph (A), and

(C) by adjusting the amounts setting forth the tax to the extent necessary to reflect the adjustments in the rate brackets.

(3) Cost-of-living adjustment

For purposes of paragraph (2), the cost-of-living adjustment for any calendar year is the percentage (if any) by which—

(A) the CPI for the preceding calendar year, exceeds

(B) the CPI for the calendar year 1992.

(4) CPI for any calendar year

For purposes of paragraph (3), the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on August 31 of such calendar year.

(5) Consumer Price Index

For purposes of paragraph (4), the term "Consumer Price Index" means the last Consumer Price Index for all-urban consumers published by the Department of Labor. For purposes of the preceding sentence, the revision of the Consumer Price Index which is most consistent with the Consumer Price Index for calendar year 1986 shall be used.

(6) Rounding

(A) In general

If any increase determined under paragraph (2)(A), section 63 (c)(4), section 68(b)(2) or section 151 (d)(4) is not a multiple of $50, such increase shall be rounded to the next lowest multiple of $50.

(B) Table for married individuals filing separately

In the case of a married individual filing a separate return, subparagraph (A) (other than with respect to sections 63 (c)(4) and 151 (d)(4)(A)) shall be applied by substituting "$25" for "$50" each place it appears.

(7) Special rule for certain brackets

(A) Calendar year 1994

In prescribing the tables under paragraph (1) which apply with respect to taxable years beginning in calendar year 1994, the Secretary shall make no adjustment to the dollar amounts at which the 36 percent rate bracket begins or at which the 39.6 percent rate begins under any table contained in subsection (a), (b), (c), (d), or (e).

(B) Later calendar years

In prescribing tables under paragraph (1) which apply with respect to taxable years beginning in a calendar year after 1994, the cost-of-living adjustment used in making adjustments to the dollar amounts referred to in subparagraph (A) shall be determined under paragraph (3) by substituting "1993" for "1992".

(8) Elimination of marriage penalty in 15-percent bracket

With respect to taxable years beginning after December 31, 2003, in prescribing the tables under paragraph (1)—

(A) the maximum taxable income in the 15-percent rate bracket in the table contained in subsection (a) (and the minimum taxable income in the next higher taxable income bracket in such table) shall be 200 percent of the maximum taxable income in the 15-percent rate bracket in the table contained in subsection (c) (after any other adjustment under this subsection), and

(B) the comparable taxable income amounts in the table contained in subsection (d) shall be 1/2 of the amounts determined under subparagraph (A).

(g) Certain unearned income of minor children taxed as if parent's income

(1) In general

In the case of any child to whom this subsection applies, the tax imposed by this section shall be equal to the greater of—

(A) the tax imposed by this section without regard to this subsection, or

(B) the sum of—

(i) the tax which would be imposed by this section if the taxable income of such child for the taxable year were reduced by the net unearned income of such child, plus

(ii) such child's share of the allocable parental tax.

(2) Child to whom subsection applies

This subsection shall apply to any child for any taxable year if—

(A) such child has not attained age 14 before the close of the taxable year, and

(B) either parent of such child is alive at the close of the taxable year.

(3) Allocable parental tax

For purposes of this subsection—

(A) In general

The term "allocable parental tax" means the excess of—

(i) the tax which would be imposed by this section on the parent's taxable income if such income included the net unearned income of all children of the parent to whom this subsection applies, over

(ii) the tax imposed by this section on the parent without regard to this subsection.

For purposes of clause (i), net unearned income of all children of the parent shall not be taken into account in computing any exclusion, deduction, or credit of the parent.

(B) Child's share

A child's share of any allocable parental tax of a parent shall be equal to an amount which bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the aggregate net unearned income of all children of such parent to whom this subsection applies.

(C) Special rule where parent has different taxable year

Except as provided in regulations, if the parent does not have the same taxable year as the child, the allocable parental tax shall be determined on the basis of the taxable year of the parent ending in the child's taxable year.

(4) Net unearned income

For purposes of this subsection—

(A) In general

The term "net unearned income" means the excess of—

(i) the portion of the adjusted gross income for the taxable year which is not attributable to earned income (as defined in section

911 (d)(2)), over

(ii) the sum of—

(I) the amount in effect for the taxable year under section 63 (c)(5)(A) (relating to limitation on standard deduction in the case of certain dependents), plus

(II) the greater of the amount described in subclause (I) or, if the child itemizes his deductions for the taxable year, the amount of the itemized deductions allowed by this chapter for the taxable year which are directly connected with the production of the portion of adjusted gross income referred to in clause (i).

(B) Limitation based on taxable income

The amount of the net unearned income for any taxable year shall not exceed the individual's taxable income for such taxable year.

(5) Special rules for determining parent to whom subsection applies

For purposes of this subsection, the parent whose taxable income shall be taken into account shall be—

(A) in the case of parents who are not married (within the meaning of section 7703), the custodial parent (within the meaning of section 152 (e)) of the child, and

(B) in the case of married individuals filing separately, the individual with the greater taxable income.

(6) Providing of parent's TIN

The parent of any child to whom this subsection applies for any taxable year shall provide the TIN of such parent to such child and such child shall include such TIN on the child's return of tax imposed by this section for such taxable year.

(7) Election to claim certain unearned income of child on parent's return

(A) In general

If—

(i) any child to whom this subsection applies has gross income for the taxable year only from interest and dividends (including Alaska Permanent Fund dividends),

(ii) such gross income is more than the amount described in paragraph (4)(A)(ii)(I) and less than 10 times the amount so described,

(iii) no estimated tax payments for such year are made in the name and TIN of such child, and no amount has been deducted and withheld under section 3406, and

(iv) the parent of such child (as determined under paragraph (5)) elects the application of subparagraph (B),

such child shall be treated (other than for purposes of this paragraph) as having no gross income for such year and shall not be required to file a return under section 6012.

(B) Income included on parent's return

In the case of a parent making the election under this paragraph—

(i) the gross income of each child to whom such election applies (to the extent the gross income of such child exceeds twice the amount described in paragraph (4)(A)(ii)(I)) shall be included in such parent's gross income for the taxable year,

(ii) the tax imposed by this section for such year with respect to such parent shall be the amount equal to the sum of—

(I) the amount determined under this section after the application of clause (i), plus

(II) for each such child, 10 percent of the lesser of the amount described in paragraph (4)(A)(ii)(I) or the excess of the gross income of such child over the amount so described, and

(iii) any interest which is an item of tax preference under section 57(a)(5) of the child shall be treated as an item of tax preference of such parent (and not of such child).

(C) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph.

(h) Maximum capital gains rate

(1) In general

If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—

(A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—

(i) taxable income reduced by the net capital gain; or

(ii) the lesser of—

(I) the amount of taxable income taxed at a rate below 25 percent; or

(II) taxable income reduced by the adjusted net capital gain;

(B) 5 percent (0 percent in the case of taxable years beginning after 2007) of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of—

(i) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 25 percent, over

(ii) the taxable income reduced by the adjusted net capital gain;

(C) 15 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the amount on which a tax is determined under subparagraph (B);

(D) 25 percent of the excess (if any) of—

(i) the unrecaptured section 1250 gain (or, if less, the net capital gain (determined without regard to paragraph (11))), over

(ii) the excess (if any) of—

(I) the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over

(II) taxable income; and

(E) 28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

(2) Net capital gain taken into account as investment income

For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163 (d)(4)(B)(iii).

(3) Adjusted net capital gain

For purposes of this subsection, the term "adjusted net capital gain" means the sum of—

(A) net capital gain (determined without regard to paragraph (11)) reduced (but not below zero) by the sum of—

(i) unrecaptured section 1250 gain, and

(ii) 28-percent rate gain, plus

(B) qualified dividend income (as defined in paragraph (11)).

(4) 28-percent rate gain

For purposes of this subsection, the term "28-percent rate gain" means the excess (if any) of—

(A) the sum of—

(i) collectibles gain; and

(ii) section 1202 gain, over

(B) the sum of—

(i) collectibles loss;

(ii) the net short-term capital loss; and

(iii) the amount of long-term capital loss carried under section 1212 (b)(1)(B) to the taxable year.

(5) Collectibles gain and loss

For purposes of this subsection—

(A) In general

The terms "collectibles gain" and "collectibles loss" mean gain or loss (respectively) from the sale or exchange of a collectible (as defined in section 408 (m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.

(B) Partnerships, etc.

For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to

the rules of section 751 shall apply for purposes of the preceding sentence.

(6) Unrecaptured section 1250 gain

For purposes of this subsection—

(A) In general

The term "unrecaptured section 1250 gain" means the excess (if any) of—

(i) the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250 (b)(1) included all depreciation and the applicable percentage under section 1250 (a) were 100 percent, over

(ii) the excess (if any) of—

(I) the amount described in paragraph (4)(B); over

(II) the amount described in paragraph (4)(A).

(B) Limitation with respect to section 1231 property

The amount described in subparagraph (A)(i) from sales, exchanges, and conversions described in section 1231 (a)(3)(A) for any taxable year shall not exceed the net section 1231 gain (as defined in section 1231 (c)(3)) for such year.

(7) Section 1202 gain

For purposes of this subsection, the term "section 1202 gain" means the excess of—

(A) the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202 (a), over

(B) the gain excluded from gross income under section 1202.

(8) Coordination with recapture of net ordinary losses under section 1231

If any amount is treated as ordinary income under section 1231 (c), such amount shall be allocated among the separate categories of net section 1231 gain (as defined in section 1231 (c)(3)) in such manner as the Secretary may by forms or regulations prescribe.

(9) Regulations

The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to apply this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities.

(10) Pass-thru entity defined

For purposes of this subsection, the term "pass-thru entity" means—

(A) a regulated investment company;

(B) a real estate investment trust;

(C) an S corporation;

(D) a partnership;

(E) an estate or trust;

(F) a common trust fund; and

(G) a qualified electing fund (as defined in section 1295).

(11) Dividends taxed as net capital gain

(A) In general

For purposes of this subsection, the term "net capital gain" means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.

(B) Qualified dividend income

For purposes of this paragraph—

(i) In general The term "qualified dividend income" means dividends received during the taxable year from—

(I) domestic corporations, and

(II) qualified foreign corporations.

(ii) Certain dividends excluded Such term shall not include—

(I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,

(II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and

(III) any dividend described in section 404 (k).

(iii) Coordination with section 246 (c) Such term shall not include any dividend on any share of stock—

(I) with respect to which the holding period requirements of section 246 (c) are not met (determined by substituting in section 246 (c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or

(II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(C) Qualified foreign corporations

(i) In general Except as otherwise provided in this paragraph, the term "qualified foreign corporation" means any foreign corporation if—

(I) such corporation is incorporated in a possession of the United States, or

(II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.

(ii) Dividends on stock readily tradable on United States securities market A foreign corporation not otherwise treated as a qualified foreign corporation under clause (i) shall be so treated with

respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.

(iii) Exclusion of dividends of certain foreign corporations Such term shall not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297).

(iv) Coordination with foreign tax credit limitation Rules similar to the rules of section 904 (b)(2)(B) shall apply with respect to the dividend rate differential under this paragraph.

(D) Special rules

(i) Amounts taken into account as investment income Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163 (d)(4)(B).

(ii) Extraordinary dividends If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059 (c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) Treatment of dividends from regulated investment companies and real estate investment trusts A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

(i) Rate reductions after 2000

(1) 10-percent rate bracket

(A) In general

In the case of taxable years beginning after December 31, 2000—

(i) the rate of tax under subsections (a), (b), (c), and (d) on taxable income not over the initial bracket amount shall be 10 percent, and

(ii) the 15 percent rate of tax shall apply only to taxable income over the initial bracket amount but not over the maximum dollar amount for the 15-percent rate bracket.

(B) Initial bracket amount

For purposes of this paragraph, the initial bracket amount is—

(i) $14,000 in the case of subsection (a),

(ii) $10,000 in the case of subsection (b), and

(iii) 1/2 the amount applicable under clause (i) (after adjustment, if any, under subparagraph (C)) in the case of subsections (c) and (d).

(C) Inflation adjustment

In prescribing the tables under subsection (f) which apply with respect to taxable years beginning in calendar years after 2003—

(i) the cost-of-living adjustment shall be determined under subsection (f)(3) by substituting "2002" for "1992" in subparagraph (B) thereof, and

(ii) the adjustments under clause (i) shall not apply to the amount referred to in subparagraph (B)(iii).

If any amount after adjustment under the preceding sentence is not a multiple of $50, such amount shall be rounded to the next lowest multiple of $50.

(D) Coordination with acceleration of 10 percent rate bracket benefit for 2001

This paragraph shall not apply to any taxable year to which section 6428 applies.

(2) Reductions in rates after June 30, 2001

In the case of taxable years beginning in a calendar year after 2000, the corresponding percentage specified for such calendar year in the following table shall be substituted for the otherwise applicable tax rate in the tables under subsections (a), (b), (c), (d), and (e).

In the case of taxable years beginning during calendar year:	The corresponding percentages shall be substituted for the following percentages:	28%	31%	36%	39.6%
2001	27.5%	30.5%	35.5%	39.1%	
2002	27.0%	30.0%	35.0%	38.6%	
2003 and thereafter	25.0%	28.0%	33.0%	35.0%	

(3) Adjustment of tables

The Secretary shall adjust the tables prescribed under subsection (f) to carry out this subsection.

Prev | Next

§ 63. Taxable income defined

(a) In general

Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

(b) Individuals who do not itemize their deductions

In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, minus—

(1) the standard deduction, and

(2) the deduction for personal exemptions provided in section 151.

(c) Standard deduction

For purposes of this subtitle—

(1) In general

Except as otherwise provided in this subsection, the term "standard deduction" means the sum of—

(A) the basic standard deduction, and

(B) the additional standard deduction.

(2) Basic standard deduction

For purposes of paragraph (1), the basic standard deduction is—

(A) 200 percent of the dollar amount in effect under subparagraph

(C) for the taxable year in the case of—

(i) a joint return, or

(ii) a surviving spouse (as defined in section 2 (a)),

(B) $4,400 in the case of a head of household (as defined in section 2 (b)), or

(C) $3,000 in any other case.

(3) Additional standard deduction for aged and blind

For purposes of paragraph (1), the additional standard deduction is the sum of each additional amount to which the taxpayer is entitled under subsection (f).

(4) Adjustments for inflation

In the case of any taxable year beginning in a calendar year after 1988, each dollar amount contained in paragraph (2)(B), (2)(C), or (5) or subsection (f) shall be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1 (f)(3) for the calendar year in which the taxable year begins, by substituting for "calendar year 1992" in subparagraph (B) thereof—

(i) "calendar year 1987" in the case of the dollar amounts contained in paragraph (2)(B), (2)(C), or (5)(A) or subsection (f), and

(ii) "calendar year 1997" in the case of the dollar amount contained in paragraph (5)(B).

(5) Limitation on basic standard deduction in the case of certain dependents

In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the basic standard deduction applicable to such individual for such individual's taxable year shall not exceed the greater of—

(A) $500, or

(B) the sum of $250 and such individual's earned income.

(6) Certain individuals, etc., not eligible for standard deduction

In the case of—

(A) a married individual filing a separate return where either spouse itemizes deductions,

(B) a nonresident alien individual,

(C) an individual making a return under section 443 (a)(1) for a period of less than 12 months on account of a change in his annual accounting period, or

(D) an estate or trust, common trust fund, or partnership,

the standard deduction shall be zero.

(d) Itemized deductions

For purposes of this subtitle, the term "itemized deductions" means the deductions allowable under this chapter other than—

(1) the deductions allowable in arriving at adjusted gross income, and

(2) the deduction for personal exemptions provided by section 151.

(e) Election to itemize

(1) In general

Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year. For purposes of this subtitle, the determination of whether a deduction is allowable under this chapter shall be made without regard to the preceding sentence.

(2) Time and manner of election

Any election under this subsection shall be made on the taxpayer's return, and the Secretary shall prescribe the manner of signifying such election on the return.

(3) Change of election

Under regulations prescribed by the Secretary, a change of election with respect to itemized deductions for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(A) the spouse makes a change of election with respect to itemized deductions, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

(B) the taxpayer and his spouse consent in writing to the assessment (within such period as may be agreed on with the Secretary) of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse for the taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122.

(f) Aged or blind additional amounts

(1) Additional amounts for the aged

The taxpayer shall be entitled to an additional amount of $600—

(A) for himself if he has attained age 65 before the close of his taxable year, and

(B) for the spouse of the taxpayer if the spouse has attained age 65 before the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151 (b).

(2) Additional amount for blind

The taxpayer shall be entitled to an additional amount of $600—

(A) for himself if he is blind at the close of the taxable year, and

(B) for the spouse of the taxpayer if the spouse is blind as of the

close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151 (b).

For purposes of subparagraph (B), if the spouse dies during the taxable year the determination of whether such spouse is blind shall be made as of the time of such death.

(3) Higher amount for certain unmarried individuals

In the case of an individual who is not married and is not a surviving spouse, paragraphs (1) and (2) shall be applied by substituting "$750" for "$600".

(4) Blindness defined

For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(g) Marital status

For purposes of this section, marital status shall be determined under section 7703.

Prev | Next

Sec. 1. - Tax imposed

(a) Married individuals filing joint returns and surviving spouses

There is hereby imposed on the taxable income of -

(1)

every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

(2)

every surviving spouse (as defined in section 2(a)),

a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $36,900	15% of taxable income.
Over $36,900 but not over $89,150	$5,535, plus 28% of the excess over $36,900.
Over $89,150 but not over $140,000	$20,165, plus 31% of the excess over $89,150.
Over $140,000 but not over $250,000	$35,928.50, plus 36% of the excess over $140,000.
Over $250,000	$75,528.50, plus 39.6% of the excess over $250,000.

(b) Heads of households

There is hereby imposed on the taxable income of every head of a household (as defined in section 2(b)) a tax determined in accordance with the following table:

If taxable income is:	The tax is:

Search this title:

Search Title 26

Notes
Updates
Parallel authorities (CFR)
Topical references

Not over $29,600	15% of taxable income.
Over $29,600 but not over $76,400	$4,440, plus 28% of the excess over $29,600.
Over $76,400 but not over $127,500	$17,544, plus 31% of the excess over $76,400.
Over $127,500 but not over $250,000	$33,385, plus 36% of the excess over $127,500.
Over $250,000	$77,485, plus 39.6% of the excess over $250,000.

(c) Unmarried individuals (other than surviving spouses and heads of households)

There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $22,100	15% of taxable income.
Over $22,100 but not over $53,500	$3,315, plus 28% of the excess over $22,100.
Over $53,500 but not over $115,000	$12,107, plus 31% of the excess over $53,500.
Over $115,000 but not over $250,000	$31,172, plus 36% of the excess over $115,000.
Over $250,000	$79,772, plus 39.6% of the excess over $250,000.

(d) Married individuals filing separate returns

There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

If taxable income is:	The tax is:
Not over $18,450	15% of taxable income.
Over $18,450 but not over $44,575	$2,767.50, plus 28% of the excess over $18,450.
Over $44,575 but not over $70,000	$10,082.50, plus 31% of the excess over $44,575.

Over $70,000 but not over $125,000	$17,964.25, plus 36% of the excess over $70,000.
Over $125,000	$37,764.25, plus 39.6% of the excess over $125,000.

(e) Estates and trusts

There is hereby imposed on the taxable income of -

(1)

every estate, and

(2)

every trust,

taxable under this subsection a tax determined in accordance with the following table

If taxable income is:	**The tax is:**
Not over $1,500	15% of taxable income.
Over $1,500 but not over $3,500	$225, plus 28% of the excess over $1,500.
Over $3,500 but not over $5,500	$785, plus 31% of the excess over $3,500.
Over $5,500 but not over $7,500	$1,405, plus 36% of the excess over $5,500.
Over $7,500	$2,125, plus 39.6% of the excess over $7,500.

(f) Adjustments in tax tables so that inflation will not result in tax increases

(1) In general

Not later than December 15 of 1993, and each subsequent calendar year, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in subsections (a), (b), (c), (d), and (e) with respect to taxable years beginning in the succeeding calendar year.

(2) Method of prescribing tables

The table which under paragraph (1) is to apply in lieu of the table contained in subsection (a), (b), (c), (d), or (e), as the case may be, with respect to taxable years beginning in any calendar year shall be prescribed -

(A)

by increasing the minimum and maximum dollar amounts for each rate bracket for which a tax is imposed under such table by the cost-of-living adjustment for such calendar year,

(B)

by not changing the rate applicable to any rate bracket as adjusted under subparagraph (A), and

(C)

by adjusting the amounts setting forth the tax to the extent necessary to reflect the adjustments in the rate brackets.

(3) Cost-of-living adjustment

For purposes of paragraph (2), the cost-of-living adjustment for any calendar year is the percentage (if any) by which -

(A)

the CPI for the preceding calendar year, exceeds

(B)

the CPI for the calendar year 1992.

(4) CPI for any calendar year

For purposes of paragraph (3), the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on August 31 of such calendar year.

(5) Consumer Price Index

For purposes of paragraph (4), the term ''Consumer Price Index'' means the last Consumer Price Index for all-urban consumers published by the Department of Labor. For purposes of the preceding sentence, the revision of the Consumer Price Index which is most consistent with the Consumer Price Index for calendar year 1986 shall be used.

(6) Rounding

(A) In general

If any increase determined under paragraph (2)(A), section 63(c)(4), section 68(b)(2) or section 151(d)(4) is not a multiple of $50, such increase shall be

rounded to the next lowest multiple of $50.

(B) Table for married individuals filing separately

In the case of a married individual filing a separate return, subparagraph (A) (other than with respect to subsection (c)(4) of section 63 (as it applies to subsections (c)(5)(A) and (f) of such section) and section 151(d)(4)(A)) shall be applied by substituting ''$25'' for ''$50'' each place it appears.

(7) Special rule for certain brackets

(A) Calendar year 1994

In prescribing the tables under paragraph (1) which apply with respect to taxable years beginning in calendar year 1994, the Secretary shall make no adjustment to the dollar amounts at which the 36 percent rate bracket begins or at which the 39.6 percent rate begins under any table contained in subsection (a), (b), (c), (d), or (e).

(B) Later calendar years

In prescribing tables under paragraph (1) which apply with respect to taxable years beginning in a calendar year after 1994, the cost -of-living adjustment used in making adjustments to the dollar amounts referred to in subparagraph (A) shall be determined under paragraph (3) by substituting ''1993'' for ''1992''.

(g) Certain unearned income of minor children taxed as if parent's income

(1) In general

In the case of any child to whom this subsection applies, the tax imposed by this section shall be equal to the greater of -

(A)

the tax imposed by this section without regard to this subsection, or

(B)

the sum of -

(i)

the tax which would be imposed by this section if

the taxable income of such child for the taxable year were reduced by the net unearned income of such child, plus

(ii)

such child's share of the allocable parental tax.

(2) Child to whom subsection applies

This subsection shall apply to any child for any taxable year if -

(A)

such child has not attained age 14 before the close of the taxable year, and

(B)

either parent of such child is alive at the close of the taxable year.

(3) Allocable parental tax

For purposes of this subsection -

(A) In general

The term ''allocable parental tax'' means the excess of -

(i)

the tax which would be imposed by this section on the parent's taxable income if such income included the net unearned income of all children of the parent to whom this subsection applies, over

(ii)

the tax imposed by this section on the parent without regard to this subsection.

For purposes of clause (i), net unearned income of all children of the parent shall not be taken into account in computing any exclusion, deduction, or credit of the parent.

(B) Child's share

A child's share of any allocable parental tax of a parent shall be equal to an amount which bears the same ratio to the total allocable parental tax as the

child's net unearned income bears to the aggregate net unearned income of all children of such parent to whom this subsection applies.

(C) Special rule where parent has different taxable year

Except as provided in regulations, if the parent does not have the same taxable year as the child, the allocable parental tax shall be determined on the basis of the taxable year of the parent ending in the child's taxable year.

(4) Net unearned income

For purposes of this subsection -

(A) In general

The term ''net unearned income'' means the excess of -

(i)

the portion of the adjusted gross income for the taxable year which is not attributable to earned income (as defined in section 911(d)(2)), over

(ii)

the sum of -

(I)

the amount in effect for the taxable year under section 63(c)(5)(A) (relating to limitation on standard deduction in the case of certain dependents), plus

(II)

the greater of the amount described in subclause (I) or, if the child itemizes his deductions for the taxable year, the amount of the itemized deductions allowed by this chapter for the taxable year which are directly connected with the production of the portion of adjusted gross income referred to in clause (i).

(B) Limitation based on taxable income

The amount of the net unearned income for any taxable year shall not exceed the individual's taxable income for such taxable year.

(5) Special rules for determining parent to whom subsection applies

For purposes of this subsection, the parent whose taxable income shall be taken into account shall be -

(A)

in the case of parents who are not married (within the meaning of section 7703), the custodial parent (within the meaning of section 152(e)) of the child, and

(B)

in the case of married individuals filing separately, the individual with the greater taxable income.

(6) Providing of parent's TIN

The parent of any child to whom this subsection applies for any taxable year shall provide the TIN of such parent to such child and such child shall include such TIN on the child's return of tax imposed by this section for such taxable year.

(7) Election to claim certain unearned income of child on parent's return

(A) In general

If -

(i)

any child to whom this subsection applies has gross income for the taxable year only from interest and dividends (including Alaska Permanent Fund dividends),

(ii)

such gross income is more than the amount described in paragraph (4)(A)(ii)(I) and less than 10 times the amount so described,

(iii)

no estimated tax payments for such year are made in the name and TIN of such child, and no amount has been deducted and withheld under section 3406, and

(iv)

the parent of such child (as determined under paragraph (5)) elects the application of subparagraph (B),

such child shall be treated (other than for purposes of this paragraph) as having no gross income for such year and shall not be required to file a return under section 6012.

(B) Income included on parent's return

In the case of a parent making the election under this paragraph -

(i)

the gross income of each child to whom such election applies (to the extent the gross income of such child exceeds twice the amount described in paragraph (4)(A)(ii)(I)) shall be included in such parent's gross income for the taxable year,

(ii)

the tax imposed by this section for such year with respect to such parent shall be the amount equal to the sum of -

(I)

the amount determined under this section after the application of clause (i), plus

(II)

for each such child, 15 percent of the lesser of the amount described in paragraph (4)(A)(ii)(I) or the excess of the gross income of such child over the amount so described, and

(iii)

any interest which is an item of tax preference under section 57(a)(5) of the child shall be treated as an item of tax preference of such parent (and not of such child).

(C) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph.

(h) Maximum capital gains rate

(1) In general

If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of -

(A)

a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of -

(i)

taxable income reduced by the net capital gain; or

(ii)

the lesser of -

(I)

the amount of taxable income taxed at a rate below 28 percent; or

(II)

taxable income reduced by the adjusted net capital gain;

(B)

10 percent of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of -

(i)

the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 28 percent, over

(ii)

the taxable income reduced by the adjusted net capital gain;

(C)

20 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the amount on which a tax is determined under subparagraph (B);

(D)

25 percent of the excess (if any) of -

(i)

the unrecaptured section 1250 gain (or, if less, the net capital gain), over

(ii)

the excess (if any) of -

(I)

the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over

(II)

taxable income; and

(E)

28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

(2) Reduced capital gain rates for qualified 5-year gain

(A) Reduction in 10-percent rate

In the case of any taxable year beginning after December 31, 2000, the rate under paragraph (1)(B) shall be 8 percent with respect to so much of the amount to which the 10-percent rate would otherwise apply as does not exceed qualified 5-year gain, and 10 percent with respect to the remainder of such amount.

(B) Reduction in 20-percent rate

The rate under paragraph (1)(C) shall be 18 percent with respect to so much of the amount to which the 20-percent rate would otherwise apply as does not exceed the lesser of -

(i)

the excess of qualified 5-year gain over the amount of such gain taken into account under subparagraph (A) of this paragraph; or

(ii)

the amount of qualified 5-year gain (determined by taking into account only property the holding period for which begins after December 31, 2000),

and 20 percent with respect to the remainder of such amount. For purposes of determining under the preceding sentence whether the holding period of property begins after December 31, 2000, the holding period of property acquired pursuant to the exercise of an option (or other right or obligation to acquire property) shall include the period such option (or other right or obligation) was held.

(3) Net capital gain taken into account as investment income

For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii).

(4) Adjusted net capital gain

For purposes of this subsection, the term ''adjusted net capital gain'' means net capital gain reduced (but not below zero) by the sum of -

(A)

unrecaptured section 1250 gain; and

(B)

28-percent rate gain.

(5) 28-percent rate gain

For purposes of this subsection, the term ''28-percent rate gain'' means the excess (if any) of -

(A)

the sum of -

(i)

collectibles gain; and

(ii)

section 1202 gain, over

(B)

the sum of -

(i)

collectibles loss;

(ii)

the net short-term capital loss; and

(iii)

the amount of long-term capital loss carried under section 1212(b)(1)(B) to the taxable year.

(6) Collectibles gain and loss

For purposes of this subsection -

(A) In general

The terms ''collectibles gain'' and ''collectibles loss'' mean gain or loss (respectively) from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.

(B) Partnerships, etc.

For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to the rules of section 751 shall apply for purposes of the preceding sentence.

(7) Unrecaptured section 1250 gain

For purposes of this subsection -

(A) In general

The term ''unrecaptured section 1250 gain'' means the excess (if any) of -

(i)

the amount of long-term capital gain (not otherwise treated as ordinary income) which would

be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, over

(ii)

the excess (if any) of -

(I)

the amount described in paragraph (5)(B); over

(II)

the amount described in paragraph (5)(A).

(B) Limitation with respect to section 1231 property

The amount described in subparagraph (A)(i) from sales, exchanges, and conversions described in section 1231(a)(3)(A) for any taxable year shall not exceed the net section 1231 gain (as defined in section 1231 (c)(3)) for such year.

(8) Section 1202 gain

For purposes of this subsection, the term ''section 1202 gain'' means the excess of -

(A)

the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a), over

(B)

the gain excluded from gross income under section 1202.

(9) Qualified 5-year gain

For purposes of this subsection, the term ''qualified 5-year gain'' means the aggregate long-term capital gain from property held for more than 5 years. The determination under the preceding sentence shall be made without regard to collectibles gain, gain described in paragraph (7)(A)(i), and section 1202 gain.

(10) Coordination with recapture of net ordinary losses under section 1231

If any amount is treated as ordinary income under section 1231(c), such amount shall be allocated among

the separate categories of net section 1231 gain (as defined in section 1231(c)(3)) in such manner as the Secretary may by forms or regulations prescribe.

(11) Regulations

The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to apply this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities.

(12) Pass-thru entity defined

For purposes of this subsection, the term ''pass-thru entity'' means -

(A)

a regulated investment company;

(B)

a real estate investment trust;

(C)

an S corporation;

(D)

a partnership;

(E)

an estate or trust;

(F)

a common trust fund;

(G)

a foreign investment company which is described in section 1246(b)(1) and for which an election is in effect under section 1247; and

(H)

a qualified electing fund (as defined in section 1295).

(13) Special rules

(A) Determination of 28-percent rate gain

In applying paragraph (5) -

(i)

the amount determined under subparagraph (A) of paragraph (5) shall include long-term capital gain (not otherwise described in such subparagraph) -

(I)

which is properly taken into account for the portion of the taxable year before May 7, 1997; or

(II)

from property held not more than 18 months which is properly taken into account for the portion of the taxable year after July 28, 1997, and before January 1, 1998;

(ii)

the amount determined under subparagraph (B) of paragraph (5) shall include long-term capital loss (not otherwise described in such subparagraph) -

(I)

which is properly taken into account for the portion of the taxable year before May 7, 1997; or

(II)

from property held not more than 18 months which is properly taken into account for the portion of the taxable year after July 28, 1997, and before January 1, 1998; and

(iii)

subparagraph (B) of paragraph (5) (as in effect immediately before the enactment of this clause) shall apply to amounts properly taken into account before January 1, 1998.

(B) Determination of unrecaptured section 1250 gain

The amount determined under paragraph (7)(A)(i) shall not include gain -

(i)

which is properly taken into account for the portion

of the taxable year before May 7, 1997; or

(ii)

from property held not more than 18 months which is properly taken into account for the portion of the taxable year after July 28, 1997, and before January 1, 1998.

(C) Special rules for pass-thru entities

In applying this paragraph with respect to any pass-thru entity, the determination of when gains and loss are properly taken into account shall be made at the entity level.

(D) Charitable remainder trusts

Subparagraphs (A) and (B)(ii) shall not apply to any capital gain distribution made by a trust described in section 664.'

Next

Sec. 63. - Taxable income defined

(a) In general

Except as provided in subsection (b), for purposes of this subtitle, the term ''taxable income'' means gross income minus the deductions allowed by this chapter (other than the standard deduction).

(b) Individuals who do not itemize their deductions

In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term ''taxable income'' means adjusted gross income, minus -

(1)

the standard deduction, and

(2)

the deduction for personal exemptions provided in section 151.

(c) Standard deduction

For purposes of this subtitle -

(1) In general

Except as otherwise provided in this subsection, the term ''standard deduction'' means the sum of -

(A)

the basic standard deduction, and

(B)

the additional standard deduction.

(2) Basic standard deduction

For purposes of paragraph (1), the basic standard deduction is -

(A)

$5,000 in the case of -

(i)

a joint return, or

(ii)

a surviving spouse (as defined in section 2(a)),

(B)

$4,400 in the case of a head of household (as defined in section 2(b)),

(C)

$3,000 in the case of an individual who is not married and who is not a surviving spouse or head of household, or

(D)

$2,500 in the case of a married individual filing a separate return.

(3) Additional standard deduction for aged and blind

For purposes of paragraph (1), the additional standard deduction is the sum of each additional amount to which the taxpayer is entitled under subsection (f).

(4) Adjustments for inflation

In the case of any taxable year beginning in a calendar year after 1988, each dollar amount contained in paragraph (2) or (5) or subsection (f) shall be increased by an amount equal to -

(A)

such dollar amount, multiplied by

(B)

the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting for ''calendar year

1992'' in subparagraph (B) thereof -

(i)

''calendar year 1987'' in the case of the dollar amounts contained in paragraph (2) or (5)(A) or subsection (f), and

(ii)

''calendar year 1997'' in the case of the dollar amount contained in paragraph (5)(B).

(5) Limitation on basic standard deduction in the case of certain dependents

In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the basic standard deduction applicable to such individual for such individual's taxable year shall not exceed the greater of -

(A)

$500, or

(B)

the sum of $250 and such individual's earned income.

(6) Certain individuals, etc., not eligible for standard deduction

In the case of -

(A)

a married individual filing a separate return where either spouse itemizes deductions,

(B)

a nonresident alien individual,

(C)

an individual making a return under section 443 (a)(1) for a period of less than 12 months on account of a change in his annual accounting period, or

(D)

an estate or trust, common trust fund, or partnership,

the standard deduction shall be zero.

(d) Itemized deductions

For purposes of this subtitle, the term ''itemized deductions'' means the deductions allowable under this chapter other than -

(1)

the deductions allowable in arriving at adjusted gross income, and

(2)

the deduction for personal exemptions provided by section 151.

(e) Election to itemize

(1) In general

Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year. For purposes of this subtitle, the determination of whether a deduction is allowable under this chapter shall be made without regard to the preceding sentence.

(2) Time and manner of election

Any election under this subsection shall be made on the taxpayer's return, and the Secretary shall prescribe the manner of signifying such election on the return.

(3) Change of election

Under regulations prescribed by the Secretary, a change of election with respect to itemized deductions for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations -

(A)

the spouse makes a change of election with respect to itemized deductions, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

(B)

the taxpayer and his spouse consent in writing to the assessment (within such period as may be agreed on with the Secretary) of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse for the taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122.

(f) Aged or blind additional amounts

(1) Additional amounts for the aged

The taxpayer shall be entitled to an additional amount of $600 -

(A)

for himself if he has attained age 65 before the close of his taxable year, and

(B)

for the spouse of the taxpayer if the spouse has attained age 65 before the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b).

(2) Additional amount for blind

The taxpayer shall be entitled to an additional amount of $600 -

(A)

for himself if he is blind at the close of the taxable year, and

(B)

for the spouse of the taxpayer if the spouse is blind as of the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b).

For purposes of subparagraph (B), if the spouse dies during the taxable year the determination of whether such spouse is blind shall be made as of the time of such

death.

(3) Higher amount for certain unmarried individuals

In the case of an individual who is not married and is not a surviving spouse, paragraphs (1) and (2) shall be applied by substituting ''$750'' for ''$600''.

(4) Blindness defined

For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(g) Marital status

For purposes of this section, marital status shall be determined under section 7703

Prev | Next

Sec. 63. - Taxable income defined

(a) In general

Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income **minus** the **deductions allowed** by this chapter (other than the standard **deduction**).

(b) Individuals who do not itemize their **deductions**

In the case of an individual who does not elect to itemize his **deductions** for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, **minus** -

(1)

the standard **deduction**, and

(2)

the **deduction** for personal exemptions provided in section 151.

(c) Standard **deduction**

For purposes of this subtitle -

(1) In general

Except as otherwise provided in this subsection, the term "standard **deduction**" means the sum of -

(A)

the basic standard **deduction**, and

(B)

the additional standard **deduction**.

(2) Basic standard **deduction**

For purposes of paragraph (1), the basic standard **deduction** is -

(A)

$5,000 in the case of -

(i)

a joint return, or

(ii)

a surviving spouse (as defined in section 2(a)),

(B)

$4,400 in the case of a head of household (as defined in section 2(b)),

(C)

$3,000 in the case of an individual who is not married and who is not a surviving spouse or head of household, or

(D)

$2,500 in the case of a married individual filing a separate return.

(3) Additional standard **deduction** for aged and blind

For purposes of paragraph (1), the additional standard **deduction** is the sum of each additional amount to which the taxpayer is entitled under subsection (f).

(4) Adjustments for inflation

In the case of any taxable year beginning in a calendar year after 1988, each dollar amount contained in paragraph (2) or (5) or subsection (f) shall be increased by an amount equal to -

(A)

such dollar amount, multiplied by

(B)

the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting for "calendar year 1992" in subparagraph (B) thereof -

(i)

"calendar year 1987" in the case of the dollar amounts contained in paragraph (2) or (5)(A) or subsection (f), and

(ii)

"calendar year 1997" in the case of the dollar amount contained in paragraph (5)(B).

(5) Limitation on basic standard **deduction** in the case of certain dependents

In the case of an individual with respect to whom a **deduction** under section 151 is **allowable** to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the basic standard **deduction** applicable to such individual for such individual's taxable year shall not exceed the greater of -

(A)

$500, or

(B)

the sum of $250 and such individual's earned income.

(6) Certain individuals, etc., not eligible for standard **deduction**

In the case of -

(A)

a married individual filing a separate return where either spouse itemizes **deductions**,

(B)

a nonresident alien individual,

(C)

an individual making a return under section 443(a)(1) for a period of less than 12 months on account of a change in his annual accounting period, or

(D)

an estate or trust, common trust fund, or partnership,

the standard **deduction** shall be zero.

(d) Itemized **deductions**

For purposes of this subtitle, the term "itemized **deductions**" means the **deductions allowable** under this chapter other than -

(1)

the **deductions allowable** in arriving at adjusted gross income, and

(2)

the **deduction** for personal exemptions provided by section 151.

(e) Election to itemize

(1) In general

Unless an individual makes an election under this subsection for the taxable year, no itemized **deduction** shall be **allowed** for the taxable year. For purposes of this subtitle, the determination of whether a **deduction** is **allowable** under this chapter shall be made without regard to the preceding sentence.

(2) Time and manner of election

Any election under this subsection shall be made on the taxpayer's return, and the Secretary shall prescribe the manner of signifying such election on the return.

(3) Change of election

Under regulations prescribed by the Secretary, a change of election with respect to itemized **deductions** for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be **allowed** unless, in accordance with such regulations -

(A)

the spouse makes a change of election with respect to itemized **deductions**, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

(B)

the taxpayer and his spouse consent in writing to the assessment (within such period as may be agreed on with the Secretary) of

any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

This paragraph shall not apply if the tax liability of the taxpayer's spouse for the taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122.

(f) Aged or blind additional amounts

(1) Additional amounts for the aged

The taxpayer shall be entitled to an additional amount of $600 -

(A)

for himself if he has attained age 65 before the close of his taxable year, and

(B)

for the spouse of the taxpayer if the spouse has attained age 65 before the close of the taxable year and an additional exemption is **allowable** to the taxpayer for such spouse under section 151 (b).

(2) Additional amount for blind

The taxpayer shall be entitled to an additional amount of $600 -

(A)

for himself if he is blind at the close of the taxable year, and

(B)

for the spouse of the taxpayer if the spouse is blind as of the close of the taxable year and an additional exemption is **allowable** to the taxpayer for such spouse under section 151(b).

For purposes of subparagraph (B), if the spouse dies during the taxable year the determination of whether such spouse is blind shall be made as of the time of such death.

(3) Higher amount for certain unmarried individuals

In the case of an individual who is not married and is not a surviving spouse, paragraphs (1) and (2) shall be applied by substituting "$750" for "$600".

(4) Blindness defined

For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(g) Marital status

For purposes of this section, marital status shall be determined under section 7703

Prev | Next

§ 151. Allowance of deductions for personal exemptions

(a) Allowance of deductions

In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) Taxpayer and spouse

An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(c) Additional exemption for dependents

An exemption of the exemption amount for each individual who is a dependent (as defined in section 152) of the taxpayer for the taxable year.

(d) Exemption amount

For purposes of this section—

(1) In general

Except as otherwise provided in this subsection, the term "exemption amount" means $2,000.

(2) Exemption amount disallowed in case of certain dependents

In the case of an individual with respect to whom a deduction under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the

exemption amount applicable to such individual for such individual's taxable year shall be zero.

(3) Phaseout

(A) In general

In the case of any taxpayer whose adjusted gross income for the taxable year exceeds the threshold amount, the exemption amount shall be reduced by the applicable percentage.

(B) Applicable percentage

For purposes of subparagraph (A), the term "applicable percentage" means 2 percentage points for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds the threshold amount. In the case of a married individual filing a separate return, the preceding sentence shall be applied by substituting "$1,250" for "$2,500". In no event shall the applicable percentage exceed 100 percent.

(C) Threshold amount

For purposes of this paragraph, the term "threshold amount" means —

(i) $150,000 in the case of a joint return or a surviving spouse (as defined in section 2 (a)),

(ii) $125,000 in the case of a head of a household (as defined in section 2 (b),[1]

(iii) $100,000 in the case of an individual who is not married and who is not a surviving spouse or head of a household, and

(iv) $75,000 in the case of a married individual filing a separate return.

For purposes of this paragraph, marital status shall be determined under section 7703.

(D) Coordination with other provisions

The provisions of this paragraph shall not apply for purposes of determining whether a deduction under this section with respect to any individual is allowable to another taxpayer for any taxable year.

(4) Inflation adjustments

(A) Adjustment to basic amount of exemption

In the case of any taxable year beginning in a calendar year after 1989, the dollar amount contained in paragraph (1) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1 (f) (3) for the calendar year in which the taxable year begins, by substituting "calendar year 1988" for "calendar year 1992" in subparagraph (B) thereof.

(B) Adjustment to threshold amounts for years after 1991

In the case of any taxable year beginning in a calendar year after 1991, each dollar amount contained in paragraph (3)(C) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1 (f) (3) for the calendar year in which the taxable year begins, by substituting "calendar year 1990" for "calendar year 1992" in subparagraph (B) thereof.

(e) Identifying information required

No exemption shall be allowed under this section with respect to any individual unless the TIN of such individual is included on the return claiming the exemption.

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[1] So in original. A closing parenthesis probably should precede the comma.

Prev | Next

Sec. 151. - Allowance of deductions for personal exemptions

(a) Allowance of deductions

In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) Taxpayer and spouse

An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(c) Additional exemption for dependents

(1) In general

An exemption of the exemption amount for each dependent (as defined in section 152) -

(A)

whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the exemption amount, or

(B)

who is a child of the taxpayer and who

(i)

has not attained the age of 19 at the close of the calendar year in which the taxable year of the

taxpayer begins, or

(ii)

is a student who has not attained the age of 24 at the close of such calendar year.

(2) Exemption denied in case of certain married dependents

No exemption shall be allowed under this subsection for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

(3) Child defined

For purposes of paragraph (1)(B), the term ''child'' means an individual who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer.

(4) Student defined

For purposes of paragraph (1)(B)(ii), the term ''student'' means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins -

(A)

is a full-time student at an educational organization described in section 170(b)(1)(A)(ii); or

(B)

is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) or of a State or political subdivision of a State.

(5) Certain income of handicapped dependents not taken into account

(A) In general

For purposes of paragraph (1)(A), the gross income of an individual who is permanently and totally disabled shall not include income attributable to services performed by the individual at a sheltered workshop if -

(i)

the availability of medical care at such workshop is the principal reason for his presence there, and

(ii)

the income arises solely from activities at such workshop which are incident to such medical care.

(B) Sheltered workshop defined

For purposes of subparagraph (A), the term ''sheltered workshop'' means a school -

(i)

which provides special instruction or training designed to alleviate the disability of the individual, and

(ii)

which is operated by -

(I)

an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

(II)

a State, a possession of the United States, any political subdivision of any of the foregoing, the United States, or the District of Columbia.

(C) Permanent and total disability defined

An individual shall be treated as permanently and totally disabled for purposes of this paragraph if such individual would be so treated under paragraph (3) of section 22(e).

(6) Treatment of missing children

(A) In general

Solely for the purposes referred to in subparagraph (B), a child of the taxpayer -

(i)

who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer, and

(ii)

who was (without regard to this paragraph) the dependent of the taxpayer for the portion of the taxable year before the date of the kidnapping,

shall be treated as a dependent of the taxpayer for all taxable years ending during the period that the child is kidnapped.

(B) Purposes

Subparagraph (A) shall apply solely for purposes of determining -

(i)

the deduction under this section,

(ii)

the credit under section 24 (relating to child tax credit), and

(iii)

whether an individual is a surviving spouse or a head of a household (such terms are defined in section 2).

(C) Comparable treatment for earned income credit

For purposes of section 32, an individual -

(i)

who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such individual or the taxpayer, and

(ii)

who had, for the taxable year in which the kidnapping occurred, the same principal place of abode as the taxpayer for more than one-half of the portion of such year before the date of the kidnapping,

shall be treated as meeting the requirement of section 32(c)(3)(A)(ii) with respect to a taxpayer for all taxable years ending during the period that the individual is kidnapped.

(D) Termination of treatment

Subparagraphs (A) and (C) shall cease to apply as of the first taxable year of the taxpayer beginning after the calendar year in which there is a determination that the child is dead (or, if earlier, in which the child would have attained age 18).

(d) Exemption amount

For purposes of this section -

(1) In general

Except as otherwise provided in this subsection, the term ''exemption amount'' means $2,000.

(2) Exemption amount disallowed in case of certain dependents

In the case of an individual with respect to whom a deduction under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the exemption amount applicable to such individual for such individual's taxable year shall be zero.

(3) Phaseout

(A) In general

In the case of any taxpayer whose adjusted gross income for the taxable year exceeds the threshold amount, the exemption amount shall be reduced by the applicable percentage.

(B) Applicable percentage

For purposes of subparagraph (A), the term ''applicable percentage'' means 2 percentage points for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds the threshold amount. In the case of a married individual filing a separate return, the preceding sentence shall be applied by substituting ''$1,250'' for ''$2,500''. In no event shall the applicable percentage exceed 100 percent.

(C) Threshold amount

For purposes of this paragraph, the term ''threshold amount'' means -

(i)

$150,000 in the case of a joint return or a surviving spouse (as defined in section 2(a)),

(ii)

$125,000 in the case of a head of a household (as defined in section 2(b), [1]

(iii)

$100,000 in the case of an individual who is not married and who is not a surviving spouse or head of a household, and

(iv)

$75,000 in the case of a married individual filing a separate return.

For purposes of this paragraph, marital status shall be determined under section 7703.

(D) Coordination with other provisions

The provisions of this paragraph shall not apply for purposes of determining whether a deduction under this section with respect to any individual is allowable to another taxpayer for any taxable year.

(4) Inflation adjustments

(A) Adjustment to basic amount of exemption

In the case of any taxable year beginning in a calendar year after 1989, the dollar amount contained in paragraph (1) shall be increased by an amount equal to -

(i)

such dollar amount, multiplied by

(ii)

the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting ''calendar year 1988'' for ''calendar year 1992'' in subparagraph (B) thereof.

(B) Adjustment to threshold amounts for years after 1991

In the case of any taxable year beginning in a calendar year after 1991, each dollar amount

contained in paragraph (3)(C) shall be increased by an amount equal to -

(i)

such dollar amount, multiplied by

(ii)

the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting ''calendar year 1990'' for ''calendar year 1992'' in subparagraph (B) thereof.

(e) Identifying information required

No exemption shall be allowed under this section with respect to any individual unless the TIN of such individual is included on the return claiming the exemption

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[1] So in original. A closing parenthesis probably should precede the comma.

Next

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26 U.S.C.A. § 62 **This document has been updated. Use KEYCITE.**

I.R.C. § 62

UNITED STATES CODE ANNOTATED

TITLE 26. INTERNAL REVENUE CODE

SUBTITLE A--INCOME TAXES

CHAPTER 1--NORMAL TAXES AND SURTAXES

SUBCHAPTER B--COMPUTATION OF TAXABLE INCOME

PART I--DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, TAXABLE INCOME, ETC.

Current through P.L. 107-11, approved 5-28-01

§ 62. Adjusted gross income defined

(a) General rule.--For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following

Date of Download: Sep 14, 2001

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26 U.S.C.A. § 3101 I.R.C. § 3101

UNITED STATES CODE ANNOTATED

TITLE 26. INTERNAL REVENUE CODE

SUBTITLE C--EMPLOYMENT TAXES

CHAPTER 21--FEDERAL INSURANCE CONTRIBUTIONS ACT

SUBCHAPTER A--TAX ON EMPLOYEES

Current through P.L. 107-11, approved 5-28-01

§ 3101. Rate of tax

(a) Old-age, survivors, and disability insurance.--In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121 (a)) received by him with respect to employment (as defined in section 3121(b))--

In cases of wages received during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent.

(b) Hospital insurance.--In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))--

(1) with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages received during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4) with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

(c) Relief from taxes in cases covered by certain international agreements.-- During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement to taxes or contributions for similar purposes under the social security system of such foreign country.

CREDIT(S)

1989 Main Volume

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<General Materials (GM) - References, Annotations, or Tables>

U.S. Code collection

TITLE 26 > Subtitle C

Subtitle C—Employment Taxes

How Current is This?

- CHAPTER 21—FEDERAL INSURANCE CONTRIBUTIONS ACT
- CHAPTER 22—RAILROAD RETIREMENT TAX ACT
- CHAPTER 23—FEDERAL UNEMPLOYMENT TAX ACT
- CHAPTER 23A—RAILROAD UNEMPLOYMENT REPAYMENT TAX
- CHAPTER 24—COLLECTION OF INCOME TAX AT SOURCE ON WAGES
- CHAPTER 25—GENERAL PROVISIONS RELATING TO EMPLOYMENT TAXES

Level One Analysis - Title 26 Overview

TITLE 26 - INTERNAL REVENUE TITLE

SUBTITLES

A. Income Taxes Secs. 1-1552

B. Estate and Gift Taxes

C. Employment Taxes and Collection of Income Tax at source Secs. 3101-3510

D. Miscellaneous Excise Taxes

E. Alcohol, Tobacco, and Certain Other Excise Taxes

F. Procedure and Administration

G. The Joint Committee on Taxation

H. Financing o Presidential Election Campaign

SUBTITLE A - INCOME TAXES

Chapter 1. Normal Taxes and Surtaxes Secs. 1-1399

Sub-Chapters

A. Determination of Tax Liability Secs. 1-59

B. Computation of Taxable Income Secs. 61-291

C. Corporate Distributions and Adjustments

D. Deferred Compensation, etc.

E. Accounting Periods and Methods

F. Exempt Organizations

G. Corporations Used to Avoid Income Tax on Shareholders

H. Banking Institutions

I. Natural Resources

J. Estates, Trusts, Beneficiaries, and Decedents

K. Partners and Partnerships

L. Insurance Companies

M. Regulated Investment Companies and Real Estate Investment Trusts

N. Tax Based on Income from Sources Within or Without the United States Secs. 861-999

O. Gain or Loss on Disposition of Property

P. Capital Gains and Losses

Q. Readjustment of Tax Between Years and Special Limitations

R. Repealed

S. Tax Treatment of S Corporations and Their Shareholders

T. Cooperatives and their Patrons

U. Repealed [General Stock Ownership Corporations]

V. Title 11 Cases

Chapter 2. Tax on Self-Employment Income Secs. 1401-1403

Chapter 3. Withholding of Tax on Nonresident Aliens and Foreign Corporations Secs. 1441-1465

Sub-Chapters

A. Nonresident Aliens and Foreign Corporations

B. Application of Withholding Provisions

Chapter 4. Rules Applicable to Recovery of Excessive Profits on Government Contracts

Chapter 5. Tax on Transfers to Avoid Income Tax

Chapter 6. Consolidated Returns

SUBTITLE B - ESTATE AND GIFT TAX

SUBTITLE C - EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Level Two Analysis - Subtitle A Overview

SUBTITLE A - INCOME TAXES

Chapter 1. Normal Taxes and Surtaxes

Sub-Chapters

A. Determination of Tax Liability

Parts

I. Tax on Individuals Secs. 1-5.

II. Tax on Corporations Secs. 11-12.

III. Changes in Rates During a Taxable Year

IV. Credits against Tax

V. **[Part 5 is Missing]**

VI. Alternative Minimum Tax

VII. Environmental Tax

B. Computation of Taxable Income

Parts

I. Definition of Gross Income, Adjusted Gross Income, Taxable Income, Etc. Secs. 61-67.

II. Items Specifically Included in Gross Income.

III. Items Specifically Excluded from Gross Income.

IV. Determination of Marital Status.

V. Deductions for Personal Exemptions.

VI. Itemized Deductions for Individuals and Corporations.

VII. Additional Itemized Deductions for Individuals.

VIII. Special Deductions for Corporations.

IX. Items Not Deductible.

X. Terminal Railroad Corporations and Their Shareholders.

XI. Special Rules Relating to Corporate Preerence Items.

N. Tax Based on Income from Sources Within or Without the United States

Parts

I. Determination of Sources of Income Secs. 861-865

II. Nonresident Aliens and Foreign Corporations Secs. 871-897

III. Income from Sources Without the United States Secs. 901-989

IV. Domestic International Sales Corporations Secs. 991-997

V. International Boycott Determinations Sec. 999

Level Three Analysis - Chapter 1

SUBTITLE A - INCOME TAXES

Chapter 1. Normal Taxes and Surtaxes

Sub-Chapter A. Determination of Tax Liability.

Part I. Tax on Individuals Secs. 1-5.

Sections

1. Tax imposed.

2. Definitions and special rules.

3. Tax tables for individuals.

4. Repealed.

5. Cross references relating to Tax on individuals.

Part II. Tax on Corporations Secs. 11-12.

Sections

11. Tax imposed.

12. Cross references relating to tax on corporations.

Part IV. Credits Against Tax.

Subpart A. Nonrefundable Personal Credits Secs. 21-26.

Subpart B. Foreign Tax Credits Secs. 27-29.

Subpart C. Refundable Tax Credits Secs. 31-35.

Sub-Chapter B. Computation of Taxable Income

Part I. Definition of Gross Income, Adjusted gross income, taxable income, Etc. Secs. 61-17.

Sections

61. Gross Income Defined.

62. Adjusted Gross Income Defined.

63. Taxable Income Defined.

64. Ordinary Income Defined.

65. Ordinary Loss Defined.

Sub-Chapter N. Tax Based on Income from Sources Within or Without the United States.

Part I. Determination of Sources of Income Secs. 861-865.

Sections

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 and Special Rules.

865. Source Rules for Personal Property Sales.

Part II. Nonresident Aliens and Foreign Corporations Secs. 871-897.

Subpart A. Nonresident Alien Individuals Secs. 871-879.

Sections

871. Tax on Nonresident Alien Individuals.

872. Gross Income.

873. Deductions.

874. Allowance of Deductions and Credits.

875. Partnerships, Beneficiaries of Estates or Trusts.

876. Alien Residents of Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands.

877. Expatriation to Avoid Tax.

878. Foreign Educational, Charitable, and Certain Other Exempt Organizations.

879. Tax Treatment of Certain Community Income in the Case of Non-resident Alien Individuals.

Subpart B. Foreign Corporations Secs. 881-885.

Subpart C. Tax on Gross Transportation Income Secs. 887.

Subpart D. Miscellaneous Provisions Secs. 891-897.

Part III. Income from Sources Without the United States Secs. 901-989.

Subpart A. Foreign Tax Credit Secs. 901-908.

Sections

901. Taxes of Foreign Countries and of Possessions of United States.

906. Nonresident Alien Individuals and Foreign Corporations.

Subpart B. Earned Income Of Citizens of United States Secs. 911-912.

Sections

911. Citizens or residents of the United States living abroad

Subpart C. Taxation of Foreign Sales Corporations.

Subpart D. Possessions of the United States Secs. 931-936.

Sections

931. Income From Sources Within Guam, American Samoa, or the Northern Mariana Islands.

932. Coordination of United States and Virgin Islands Income Taxes.

933. Income From Sources Within Puerto Rico.

Subpart E. Repealed.

Subpart F. Controlled Foreign Corporations

Subpart G. Export Trade Corporations.

Subpart H. Repealed.

Subpart I. Admissibility of Documentation Maintained in Foreign Countries.

Subpart J. Foreign Currency Transactions.

Level Four Analysis - Conclusions

Chapter 1. Normal Taxes and Surtaxes

Subchapter A. Determination of Tax Liability

Part I. Tax on Individuals.

1. The tax is imposed on the taxable income of:
   a. married individuals, with marriage defined at §7703;
   b. a head of household, as defined at § 2(b);
   c. unmarried individuals;
   d. married individuals filing separate returns;
   e. estates and trusts. (Sec. 1.)
2. There are three types of "individuals":
   a. Citizens wherever resident:
      1) Must be born or naturalized in the United States; (Reg. 1.1-1(a)-(c))
      2) Must be subject to the jurisdiction of the United States; (Reg. 1.1-1(a)-(c))
   b. Aliens resident; (Sec. 7701(b); Reg. 1.1-1(a)-(b))

c. Aliens nonresident:

1) Taxed per Sec. 871; (Sec. 7701(b); Sec. 2(d); Reg. 1.1-1(a))

2) Taxed per Sec. 877; (Sec. 7701(b); Sec. 2(d); Reg. 1.1-1(a))

3) If bona fide resident of Puerto Rico for entire year is, except as provided by Sec. 933 with respect to Puerto Rican source income, subject to taxation as a resident alien. (Reg. 1.1-1(b))

3. The taxable income upon which the tax is imposed initially consists of all income and from whatever source it may be received, whether from within the United States or without the United States. Sec. 1; (Secs. 61-63; Reg. 1.1-1(b))

4. Individuals who have paid certain taxes to foreign governments and possessions of the United States are entitled to a credit. (Sec. 27)

5. Individuals are entitled to "refundable credits" against the tax imposed at Sec. 1 as follows:

1. Taxes that are collected at the source under Chapter 24, Secs. 3401-3404. (Sec. 31.);

2. Taxes that are withheld at the source upon nonresident aliens and foreign corporations per Chapter 3, Subchapter A, Secs. 1441-1446. (Sec. 33)

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.

1. Items of gross income that are to be treated as income from sources within the United States are:

a) Some interest; (Sec. 861(a)(1))

b) Some dividends; (Sec. 861(a)(2))

c) Some compensation for personal services dependent upon who performs the labor, where the labor is performed, and for whom the labor is performed (Sec. 861(a)(3))

d) Some rentals and royalties; (Sec. 861(a)(4))

e) Disposition of United States real property interests; (Sec. 861(a)(5))

f) Gains from the sale or exchange of certain personal property; (Sec. 861(a)(6))

g) Underwriting income as defined at Sec. 832(b)(3);(Sec. 861(a)(7))

h) Social Security benefits as defined in Sec. 86(d).(Sec. 861(a)(8))

2. Items of gross income that are to be treated as income from sources without the United States are:

a) Interest other than that dervied from sources within the United States; (Sec. 862(a)(1))

b) Dividends other than those derived from sources within the United States; (Sec. 862(a)(2))

c) Compensation for labor or personal services performed without the United States; (Sec. 862(a)(3))

d) Rentals or royalties from property located outside the United States, and others; (Sec. 862(a)(4))

e) Gains from the sale or exchange of real property located without the United States; (Sec. 862(a)(5))

f) Gains from the sale or exchange o certain personal property; (Sec. 862(a)(6))

g) Underwriting income other than that derived from sources within the United States as provided in Sec. 861(a)(7); (Sec. 862(a)(7))

h) Gains from the disposition of a United States real property interest as defined in Sec. 897(c) when the real property is located in the Virgin Islands. (Sec. 862(a)(8))

3. Items of gross income not specified by statute are to be allocated or apportioned to sources within and without the United States by Regulations. (Sec. 863)

4. Except as otherwise provided in the section, income from the sale of personal property is sourced:

a) In the United States if the seller of the property was a United States resident; (Sec. 865(a)(1))

b) Out of the United States if the seller of the property was not a Untied States resident. (Sec. 865(a)(2))

1) For purposes of this section, a “United States resident” is defined as one who has his tax home as defined in Sec. 911(d)(3) in the United States; (Sec. 865()(1)(A))

2) For purposes of this section, a “nonresident” is any person other than a United States resident. (Sec. 865(g)(1)(B))

Part II. Nonresident Aliens and Foreign Corporations.

Subpart A. Nonresident alien individuals

1. A tax of 30% is imposed on amounts received by a nonresident alien that are not associated with a trade or business but are otherwise received from sources within the United States. (Sec. 871(a)(1)(A))

2. A tax as provided in Section 1, 55 or 402(e)(1) shall apply to nonresident aliens on their taxable income which is effectively connected with the conduct of a trade or business within the United States. (Sec. 871(a)(1)(B))

3. As to nonresident aliens, the definition of gross income is modified to only include income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States. (Sec. 872(a)(1))

4. As to nonresident aliens, they are entitled to certain exclusions, deductions and credits. (Secs. 872(b)-874)

5. There are special rules for nonresident aliens who were United States citizens but expatriated themselves for tax avoidance purposes. (Sec. 877)

Part III. Income From Sources Without the United States.

Subpart A. Foreign Tax Credit

1. If a taxpayer elects the benefit of this subpart, then the tax imposed by Chapter 1, subject to the limitation of Sec. 904, shall be credited with:

a. In the case of a citizen of the United States, the amount of taxes paid to a foreign government or to any possession of the United States; (Sec. 901(a)-(b)(1))

b. In the case of a resident of the United States and of an individual who is a bona fide full year resident of Puerto Rico, the amount of taxes paid to any possession of the United States; (Sec. 901(a)-(b)(2))

c. In the case of an alien resident of the United States and of an alien individual who is a bona fide full year resident of Puerto Rico, the amount of any tax paid to any foreign country; (Sec. 901(a)-(b)(3))

d. In the case of any nonresident alien individual not described in Sec. 876, the amount determined pursuant to Sec. 906.)

Subpart B. Earned Income of Citizens or Residents of the United States

1. At the election of a “qualified individual,” there shall be excluded from gross income of the “qualified individual”, and exempt from taxation under subtitle A:

a. The individual’s “foreign earned income”; (Sec. 911(a)(1))

b. The individual's housing cost. (Sec. 911(a)(2))

c. "Foreign earned income" is basically the amount received from sources within a foreign country; (Sec. 911(b)(1))

d. A "qualified individual" is an individual whose tax home is in a foreign country and is:

1) A citizen of the United States who establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries or an uninterrupted period which includes an entire taxable year; (Sec. 911(d)(1)(A))

or

2) A citizen or resident of the United States and who during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days. (Sec. 911(d)(1)(B))

Subpart D. Possessions of the United States

1. In the case of an individual who is a bona fide resident of Guam, American Samoa, or the Northern Mariana Islands, his gross income does not include income derived from those possessions and income effectively connected with the conduct of a trade or business by such individual within those possessions. (Sec. 931(a)(1)-(2))

2. In the case of an individual who is a citizen or resident of the United States(other than a bona fide resident of the Virgin Islands) and has income derived from sources within the Virgin Islands or effectively connected with a trade or business within the Virgin Islands, has special provisions that apply as to how much of Chapter 1 imposed taxes is to be paid to the United States and how much to the Virgin Islands. (Sec. 932 (a)-(b))

3. In the case of an individual who is a bona fide resident of the Virgin Islands, for purposes of calculating income tax liability to the United States, gross income does not include any amount included in gross income on the return to the Virgin Islands. (Sec. 932(c))

4. In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, there shall be excluded from gross income of the individual, and exempt from taxation under subtitle A, income derived rom sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof). (Sec. 933)

U.S. Code collection

- main page
- faq
- index
- search

TITLE 26 > Subtitle A

Subtitle A—Income Taxes

How Current is This?

- CHAPTER 1—NORMAL TAXES AND SURTAXES
- CHAPTER 2—TAX ON SELF-EMPLOYMENT INCOME
- CHAPTER 3—WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS
- [CHAPTER 4—REPEALED]
- [CHAPTER 5—REPEALED]
- CHAPTER 6—CONSOLIDATED RETURNS

§ 3101. Rate of tax

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121 (a)) received by him with respect to employment (as defined in section 3121 (b))—

In cases of wages received during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent.

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121 (a)) received by him with respect to employment (as defined in section 3121 (b))—

(1) with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages received during the calendar years 1979 and

1980, the rate shall be 1.05 percent;

(4) with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

(c) Relief from taxes in cases covered by certain international agreements

During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement exclusively to the laws applicable to the social security system of such foreign country.

Prev | Next

Sec. 3101. - Rate of tax

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 312

(b)

) -

In cases of wages received during:	**: The rate shall be:**
1984, 1985, 1986, or 1987 1988 or 1989 1990 or thereafter	5.7 percent 6.06 percent 6.2 percent.

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)) -

(1)

with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2)

with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3)

with respect to wages received during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4)

with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5)

with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6)

with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

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During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement to taxes or contributions for similar purposes under the social security system of such foreign country

Next

§ 3111. Rate of tax

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121 (a)) paid by him with respect to employment (as defined in section 3121 (b))—

In cases of wages paid during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent.

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121 (a)) paid by him with respect to employment (as defined in section 3121 (b))—

(1) with respect to wages paid during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages paid during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages paid during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4) with respect to wages paid during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages paid during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages paid after December 31, 1985, the rate shall be 1.45 percent.

(c) Relief from taxes in cases covered by certain international agreements

During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement exclusively to the laws applicable to the social security system of such foreign country.

Prev | Next

Sec. 3111. - Rate of tax

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 312

(b)

) -

In cases of wages paid during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent 6.06
1988 or 1989	percent 6.2
1990 or thereafter	percent.

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b)) -

(1)

with respect to wages paid during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2)

with respect to wages paid during the calendar year 1978, the rate shall be 1.00 percent;

(3)

with respect to wages paid during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4)

with respect to wages paid during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5)

with respect to wages paid during the calendar year 1985, the rate shall be 1.35 percent; and

(6)

with respect to wages paid after December 31, 1985, the rate shall be 1.45 percent.

(c) Relief from taxes in cases covered by certain international agreements

During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement to taxes or contributions for similar purposes under the social security system of such foreign country

Next

§ 3402. Income tax collected at source

(a) Requirement of withholding

(1) In general

Except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. Any tables or procedures prescribed under this paragraph shall—

(A) apply with respect to the amount of wages paid during such periods as the Secretary may prescribe, and

(B) be in such form, and provide for such amounts to be deducted and withheld, as the Secretary determines to be most appropriate to carry out the purposes of this chapter and to reflect the provisions of chapter 1 applicable to such periods.

(2) Amount of wages

For purposes of applying tables or procedures prescribed under paragraph (1), the term "the amount of wages" means the amount by which the wages exceed the number of withholding exemptions claimed multiplied by the amount of one such exemption. The amount of each withholding exemption shall be equal to the amount of one personal exemption provided in section 151 (b), prorated to the payroll period. The maximum number of withholding exemptions permitted shall be calculated in accordance with regulations prescribed by the Secretary under this section, taking into account any reduction in withholding to which an employee is entitled under this section.

(b) Percentage method of withholding

(1) If wages are paid with respect to a period which is not a payroll period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(2) In any case in which wages are paid by an employer without regard to any payroll period or other period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(3) In any case in which the period, or the time described in paragraph (2), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer to compute the tax to be deducted and withheld as if the aggregate of the wages paid to the employee during the calendar week were paid for a weekly payroll period.

(4) In determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(c) Wage bracket withholding

(1) At the election of the employer with respect to any employee, the employer shall deduct and withhold upon the wages paid to such employee a tax (in lieu of the tax required to be deducted and withheld under subsection (a)) determined in accordance with tables prescribed by the Secretary in accordance with paragraph (6).

(2) If wages are paid with respect to a period which is not a payroll period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(3) In any case in which wages are paid by an employer without regard to any payroll period or other period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(4) In any case in which the period, or the time described in paragraph (3), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer to determine the amount to be deducted and withheld under the tables applicable in the case of a weekly payroll period, in which case the aggregate of the wages paid to the employee during the calendar week shall be considered the weekly wages.

(5) If the wages exceed the highest wage bracket, in determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(6) In the case of wages paid after December 31, 1969, the amount deducted and withheld under paragraph (1) shall be determined in accordance with tables prescribed by the Secretary. In the tables so

prescribed, the amounts set forth as amounts of wages and amounts of income tax to be deducted and withheld shall be computed on the basis of the table for an annual payroll period prescribed pursuant to subsection (a).

(d) Tax paid by recipient

If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer; but this subsection shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

(e) Included and excluded wages

If the remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by such employer to such employee for such period shall be deemed to be wages; but if the remuneration paid by an employer to an employee for services performed during more than one-half of any such payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed to be wages.

(f) Withholding exemptions

(1) In general

An employee receiving wages shall on any day be entitled to the following withholding exemptions:

(A) an exemption for himself unless he is an individual described in section 151 (d)(2);

(B) if the employee is married, any exemption to which his spouse is entitled, or would be entitled if such spouse were an employee receiving wages, under subparagraph (A) or (D), but only if such spouse does not have in effect a withholding exemption certificate claiming such exemption;

(C) an exemption for each individual with respect to whom, on the basis of facts existing at the beginning of such day, there may reasonably be expected to be allowable an exemption under section 151 (c) for the taxable year under subtitle A in respect of which amounts deducted and withheld under this chapter in the calendar year in which such day falls are allowed as a credit;

(D) any allowance to which he is entitled under subsection (m), but only if his spouse does not have in effect a withholding exemption certificate claiming such allowance; and

(E) a standard deduction allowance which shall be an amount equal to one exemption (or more than one exemption if so prescribed by the Secretary) unless

(i) he is married (as determined under section 7703) and his spouse is an employee receiving wages subject to withholding or

(ii) he has withholding exemption certificates in effect with respect to more than one employer.

For purposes of this title, any standard deduction allowance under subparagraph (E) shall be treated as if it were denominated a withholding

exemption.

(2) Exemption certificates

(A) On commencement of employment

On or before the date of the commencement of employment with an employer, the employee shall furnish the employer with a signed withholding exemption certificate relating to the number of withholding exemptions which he claims, which shall in no event exceed the number to which he is entitled.

(B) Change of status

If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is less than the number of withholding exemptions claimed by the employee on the withholding exemption certificate then in effect with respect to him, the employee shall within 10 days thereafter furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the employee then claims, which shall in no event exceed the number to which he is entitled on such day. If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is greater than the number of withholding exemptions claimed, the employee may furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the employee then claims, which shall in no event exceed the number to which he is entitled on such day.

(C) Change of status which affects next calendar year

If on any day during the calendar year the number of withholding exemptions to which the employee will be, or may reasonably be expected to be, entitled at the beginning of his next taxable year under subtitle A is different from the number to which the employee is entitled on such day, the employee shall, in such cases and at such times as the Secretary may by regulations prescribe, furnish the employer with a withholding exemption certificate relating to the number of withholding exemptions which he claims with respect to such next taxable year, which shall in no event exceed the number to which he will be, or may reasonably be expected to be, so entitled.

(3) When certificate takes effect

(A) First certificate furnished

A withholding exemption certificate furnished the employer in cases in which no previous such certificate is in effect shall take effect as of the beginning of the first payroll period ending, or the first payment of wages made without regard to a payroll period, on or after the date on which such certificate is so furnished.

(B) Furnished to take place of existing certificate

(i) In general Except as provided in clauses (ii) and (iii), a withholding exemption certificate furnished to the employer in cases in which a previous such certificate is in effect shall take effect as of the beginning of the 1st payroll period ending (or the 1st payment of wages made without regard to a payroll period) on or after the 30th day after the day on which such certificate is so furnished.

(ii) Employer may elect earlier effective date At the election of the employer, a certificate described in clause (i) may be made

effective beginning with any payment of wages made on or after the day on which the certificate is so furnished and before the 30th day referred to in clause (i).

(iii) Change of status which affects next year Any certificate furnished pursuant to paragraph (2)(C) shall not take effect, and may not be made effective, with respect to any payment of wages made in the calendar year in which the certificate is furnished.

(4) Period during which certificate remains in effect

A withholding exemption certificate which takes effect under this subsection, or which on December 31, 1954, was in effect under the corresponding subsection of prior law, shall continue in effect with respect to the employer until another such certificate takes effect under this subsection.

(5) Form and contents of certificate

Withholding exemption certificates shall be in such form and contain such information as the Secretary may by regulations prescribe.

(6) Exemption of certain nonresident aliens

Notwithstanding the provisions of paragraph (1), a nonresident alien individual (other than an individual described in section 3401 (a)(6)(A) or (B)) shall be entitled to only one withholding exemption.

(7) Exemption where certificate with another employer is in effect

If a withholding exemption certificate is in effect with respect to one employer, an employee shall not be entitled under a certificate in effect with any other employer to any withholding exemption which he has claimed under such first certificate.

(g) Overlapping pay periods, and payment by agent or fiduciary

If a payment of wages is made to an employee by an employer—

(1) with respect to a payroll period or other period, any part of which is included in a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(2) without regard to any payroll period or other period, but on or prior to the expiration of a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(3) with respect to a period beginning in one and ending in another calendar year, or

(4) through an agent, fiduciary, or other person who also has the control, receipt, custody, or disposal of, or pays, the wages payable by another employer to such employee,

the manner of withholding and the amount to be deducted and withheld under this chapter shall be determined in accordance with regulations prescribed by the Secretary under which the withholding exemption allowed to the employee in any calendar year shall approximate the withholding exemption allowable with respect to an annual payroll period.

(h) Alternative methods of computing amount to be withheld

The Secretary may, under regulations prescribed by him, authorize—

(1) Withholding on basis of average wages

An employer—

(A) to estimate the wages which will be paid to any employee in any quarter of the calendar year,

(B) to determine the amount to be deducted and withheld upon each payment of wages to such employee during such quarter as if the appropriate average of the wages so estimated constituted the actual wages paid, and

(C) to deduct and withhold upon any payment of wages to such employee during such quarter (and, in the case of tips referred to in subsection (k), within 30 days thereafter) such amount as may be necessary to adjust the amount actually deducted and withheld upon the wages of such employee during such quarter to the amount required to be deducted and withheld during such quarter without regard to this subsection.

(2) Withholding on basis of annualized wages

An employer to determine the amount of tax to be deducted and withheld upon a payment of wages to an employee for a payroll period by —

(A) multiplying the amount of an employee's wages for a payroll period by the number of such payroll periods in the calendar year,

(B) determining the amount of tax which would be required to be deducted and withheld upon the amount determined under subparagraph (A) if such amount constituted the actual wages for the calendar year and the payroll period of the employee were an annual payroll period, and

(C) dividing the amount of tax determined under subparagraph (B) by the number of payroll periods (described in subparagraph (A)) in the calendar year.

(3) Withholding on basis of cumulative wages

An employer, in the case of any employee who requests to have the amount of tax to be withheld from his wages computed on the basis of his cumulative wages, to—

(A) add the amount of the wages to be paid to the employee for the payroll period to the total amount of wages paid by the employer to the employee during the calendar year,

(B) divide the aggregate amount of wages computed under subparagraph (A) by the number of payroll periods to which such aggregate amount of wages relates,

(C) compute the total amount of tax that would have been required to be deducted and withheld under subsection (a) if the average amount of wages (as computed under subparagraph (B)) had been paid to the employee for the number of payroll periods to which the aggregate amount of wages (computed under subparagraph (A)) relates,

(D) determine the excess, if any, of the amount of tax computed under subparagraph (C) over the total amount of tax deducted and withheld by the employer from wages paid to the employee during the calendar year, and

(E) deduct and withhold upon the payment of wages (referred to in subparagraph (A)) to the employee an amount equal to the excess (if any) computed under subparagraph (D).

(4) Other methods

An employer to determine the amount of tax to be deducted and withheld upon the wages paid to an employee by any other method which will require the employer to deduct and withhold upon such wages substantially the same amount as would be required to be deducted and withheld by applying subsection (a) or (c), either with respect to a payroll period or with respect to the entire taxable year.

(i) Changes in withholding

(1) In general

The Secretary may by regulations provide for increases in the amount of withholding otherwise required under this section in cases where the employee requests such changes.

(2) Treatment as tax

Any increased withholding under paragraph (1) shall for all purposes be considered tax required to be deducted and withheld under this chapter.

(j) Noncash remuneration to retail commission salesman

In the case of remuneration paid in any medium other than cash for services performed by an individual as a retail salesman for a person, where the service performed by such individual for such person is ordinarily performed for remuneration solely by way of cash commission an employer shall not be required to deduct or withhold any tax under this subchapter with respect to such remuneration, provided that such employer files with the Secretary such information with respect to such remuneration as the Secretary may by regulation prescribe.

(k) Tips

In the case of tips which constitute wages, subsection (a) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053 (a), and only to the extent that the tax can be deducted and withheld by the employer, at or after the time such statement is so furnished and before the close of the calendar year in which such statement is furnished, from such wages of the employee (excluding tips, but including funds turned over by the employee to the employer for the purpose of such deduction and withholding) as are under the control of the employer; and an employer who is furnished by an employee a written statement of tips (received in a calendar month) pursuant to section 6053 (a) to which paragraph (16)(B) of section 3401 (a) is applicable may deduct and withhold the tax with respect to such tips from any wages of the employee (excluding tips) under his control, even though at the time such statement is furnished the total amount of the tips included in statements furnished to the employer as having been received by the employee in such calendar month in the course of his employment by such employer is less than $20. Such tax shall not at any time be deducted and withheld in an amount which exceeds the aggregate of such wages and funds (including funds turned over under section 3102 (c)(2) or section 3202 (c)(2)) minus any tax required by section 3102 (a) or section 3202 (a) to be collected from such wages and funds.

(l) Determination and disclosure of marital status

(1) Determination of status by employer

For purposes of applying the tables in subsections (a) and (c) to a payment of wages, the employer shall treat the employee as a single person unless there is in effect with respect to such payment of wages a

withholding exemption certificate furnished to the employer by the employee after the date of the enactment of this subsection indicating that the employee is married.

(2) Disclosure of status by employee

An employee shall be entitled to furnish the employer with a withholding exemption certificate indicating he is married only if, on the day of such furnishing, he is married (determined with the application of the rules in paragraph (3)). An employee whose marital status changes from married to single shall, at such time as the Secretary may by regulations prescribe, furnish the employer with a new withholding exemption certificate.

(3) Determination of marital status

For purposes of paragraph (2), an employee shall on any day be considered—

(A) as not married, if

(i) he is legally separated from his spouse under a decree of divorce or separate maintenance, or

(ii) either he or his spouse is, or on any preceding day within the calendar year was, a nonresident alien; or

(B) as married, if

(i) his spouse (other than a spouse referred to in subparagraph (A)) died within the portion of his taxable year which precedes such day, or

(ii) his spouse died during one of the two taxable years immediately preceding the current taxable year and, on the basis of facts existing at the beginning of such day, the employee reasonably expects, at the close of his taxable year, to be a surviving spouse (as defined in section 2 (a)).

(m) Withholding allowances

Under regulations prescribed by the Secretary, an employee shall be entitled to additional withholding allowances or additional reductions in withholding under this subsection. In determining the number of additional withholding allowances or the amount of additional reductions in withholding under this subsection, the employee may take into account (to the extent and in the manner provided by such regulations)—

(1) estimated itemized deductions allowable under chapter 1 (other than the deductions referred to in section 151 and other than the deductions required to be taken into account in determining adjusted gross income under section 62 (a) (other than paragraph (10) thereof)),

(2) estimated tax credits allowable under chapter 1, and

(3) such additional deductions (including the additional standard deduction under section 63 (c)(3) for the aged and blind) and other items as may be specified by the Secretary in regulations.

(n) Employees incurring no income tax liability

Notwithstanding any other provision of this section, an employer shall not be required to deduct and withhold any tax under this chapter upon a payment of wages to an employee if there is in effect with respect to such payment a withholding exemption certificate (in such form and containing such other information as the Secretary may prescribe) furnished to the employer by

the employee certifying that the employee—

(1) incurred no liability for income tax imposed under subtitle A for his preceding taxable year, and

(2) anticipates that he will incur no liability for income tax imposed under subtitle A for his current taxable year.

The Secretary shall by regulations provide for the coordination of the provisions of this subsection with the provisions of subsection (f).

(o) Extension of withholding to certain payments other than wages

(1) General rule

For purposes of this chapter (and so much of subtitle F as relates to this chapter)—

(A) any supplemental unemployment compensation benefit paid to an individual,

(B) any payment of an annuity to an individual, if at the time the payment is made a request that such annuity be subject to withholding under this chapter is in effect, and

(C) any payment to an individual of sick pay which does not constitute wages (determined without regard to this subsection), if at the time the payment is made a request that such sick pay be subject to withholding under this chapter is in effect,

shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.

(2) Definitions

(A) Supplemental unemployment compensation benefits

For purposes of paragraph (1), the term "supplemental unemployment compensation benefits" means amounts which are paid to an employee, pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

(B) Annuity

For purposes of this subsection, the term "annuity" means any amount paid to an individual as a pension or annuity.

(C) Sick pay

For purposes of this subsection, the term "sick pay" means any amount which—

(i) is paid to an employee pursuant to a plan to which the employer is a party, and

(ii) constitutes remuneration or a payment in lieu of remuneration for any period during which the employee is temporarily absent from work on account of sickness or personal injuries.

(3) Amount withheld from annuity payments or sick pay

If a payee makes a request that an annuity or any sick pay be subject to withholding under this chapter, the amount to be deducted and withheld under this chapter from any payment to which such request applies shall

be an amount (not less than a minimum amount determined under regulations prescribed by the Secretary) specified by the payee in such request. The amount deducted and withheld with respect to a payment which is greater or less than a full payment shall bear the same relation to the specified amount as such payment bears to a full payment.

(4) Request for withholding

A request that an annuity or any sick pay be subject to withholding under this chapter—

(A) shall be made by the payee in writing to the person making the payments and shall contain the social security number of the payee,

(B) shall specify the amount to be deducted and withheld from each full payment, and

(C) shall take effect—

(i) in the case of sick pay, with respect to payments made more than 7 days after the date on which such request is furnished to the payor, or

(ii) in the case of an annuity, at such time (after the date on which such request is furnished to the payor) as the Secretary shall by regulations prescribe.

Such a request may be changed or terminated by furnishing to the person making the payments a written statement of change or termination which shall take effect in the same manner as provided in subparagraph (C). At the election of the payor, any such request (or statement of change or revocation) may take effect earlier than as provided in subparagraph (C).

(5) Special rule for sick pay paid pursuant to certain collective-bargaining agreements

In the case of any sick pay paid pursuant to a collective-bargaining agreement between employee representatives and one or more employers which contains a provision specifying that this paragraph is to apply to sick pay paid pursuant to such agreement and contains a provision for determining the amount to be deducted and withheld from each payment of such sick pay—

(A) the requirement of paragraph (1)(C) that a request for withholding be in effect shall not apply, and

(B) except as provided in subsection (n), the amounts to be deducted and withheld under this chapter shall be determined in accordance with such agreement.

The preceding sentence shall not apply with respect to sick pay paid pursuant to any agreement to any individual unless the social security number of such individual is furnished to the payor and the payor is furnished with such information as is necessary to determine whether the payment is pursuant to the agreement and to determine the amount to be deducted and withheld.

(6) Coordination with withholding on designated distributions under section 3405

This subsection shall not apply to any amount which is a designated distribution (within the meaning of section 3405 (e)(1)).

(p) Voluntary withholding agreements

(1) Certain Federal payments

(A) In general

If, at the time a specified Federal payment is made to any person, a request by such person is in effect that such payment be subject to withholding under this chapter, then for purposes of this chapter and so much of subtitle F as relates to this chapter, such payment shall be treated as if it were a payment of wages by an employer to an employee.

(B) Amount withheld

The amount to be deducted and withheld under this chapter from any payment to which any request under subparagraph (A) applies shall be an amount equal to the percentage of such payment specified in such request. Such a request shall apply to any payment only if the percentage specified is 7 percent, any percentage applicable to any of the 3 lowest income brackets in the table under section 1 (c), or such other percentage as is permitted under regulations prescribed by the Secretary.

(C) Specified Federal payments

For purposes of this paragraph, the term "specified Federal payment" means—

(i) any payment of a social security benefit (as defined in section 86 (d)),

(ii) any payment referred to in the second sentence of section 451 (d) which is treated as insurance proceeds,

(iii) any amount which is includible in gross income under section 77 (a), and

(iv) any other payment made pursuant to Federal law which is specified by the Secretary for purposes of this paragraph.

(D) Requests for withholding

Rules similar to the rules that apply to annuities under subsection (o) (4) shall apply to requests under this paragraph and paragraph (2).

(2) Voluntary withholding on unemployment benefits

If, at the time a payment of unemployment compensation (as defined in section 85 (b)) is made to any person, a request by such person is in effect that such payment be subject to withholding under this chapter, then for purposes of this chapter and so much of subtitle F as relates to this chapter, such payment shall be treated as if it were a payment of wages by an employer to an employee. The amount to be deducted and withheld under this chapter from any payment to which any request under this paragraph applies shall be an amount equal to 10 percent of such payment.

(3) Authority for other voluntary withholding

The Secretary is authorized by regulations to provide for withholding—

(A) from remuneration for services performed by an employee for the employee's employer which (without regard to this paragraph) does not constitute wages, and

(B) from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the

provisions of this chapter,

if the employer and employee, or the person making and the person receiving such other type of payment, agree to such withholding. Such agreement shall be in such form and manner as the Secretary may by regulations prescribe. For purposes of this chapter (and so much of subtitle F as relates to this chapter), remuneration or other payments with respect to which such agreement is made shall be treated as if they were wages paid by an employer to an employee to the extent that such remuneration is paid or other payments are made during the period for which the agreement is in effect.

(q) Extension of withholding to certain gambling winnings

(1) General rule

Every person, including the Government of the United States, a State, or a political subdivision thereof, or any instrumentalities of the foregoing, making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in an amount equal to the product of the third lowest rate of tax applicable under section 1 (c) and such payment.

(2) Exemption where tax otherwise withheld

In the case of any payment of winnings which are subject to withholding made to a nonresident alien individual or a foreign corporation, the tax imposed under paragraph (1) shall not apply to any such payment subject to tax under section 1441 (a) (relating to withholding on nonresident aliens) or tax under section 1442 (a) (relating to withholding on foreign corporations).

(3) Winnings which are subject to withholding

For purposes of this subsection, the term "winnings which are subject to withholding" means proceeds from a wager determined in accordance with the following:

(A) In general

Except as provided in subparagraphs (B) and (C), proceeds of more than $5,000 from a wagering transaction, if the amount of such proceeds is at least 300 times as large as the amount wagered.

(B) State-conducted lotteries

Proceeds of more than $5,000 from a wager placed in a lottery conducted by an agency of a State acting under authority of State law, but only if such wager is placed with the State agency conducting such lottery, or with its authorized employees or agents.

(C) Sweepstakes, wagering pools, certain pari-mutuel pools, jai alai, and lotteries

Proceeds of more than $5,000 from—

(i) a wager placed in a sweepstakes, wagering pool, or lottery (other than a wager described in subparagraph (B)), or

(ii) a wagering transaction in a pari-mutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered.

(4) Rules for determining proceeds from a wager

For purposes of this subsection—

(A) proceeds from a wager shall be determined by reducing the amount received by the amount of the wager, and

(B) proceeds which are not money shall be taken into account at their fair market value.

(5) Exception for bingo, keno, and slot machines

The tax imposed under paragraph (1) shall not apply to winnings from a slot machine, keno, and bingo.

(6) Statement by recipient

Every person who is to receive a payment of winnings which are subject to withholding shall furnish the person making such payment a statement, made under the penalties of perjury, containing the name, address, and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment.

(7) Coordination with other sections

For purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to this chapter, payments to any person of winnings which are subject to withholding shall be treated as if they were wages paid by an employer to an employee.

(r) Extension of withholding to certain taxable payments of Indian casino profits

(1) In general

Every person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenues of any class II or class III gaming activity conducted or licensed by such tribe shall deduct and withhold from such payment a tax in an amount equal to such payment's proportionate share of the annualized tax.

(2) Exception

The tax imposed by paragraph (1) shall not apply to any payment to the extent that the payment, when annualized, does not exceed an amount equal to the sum of—

(A) the basic standard deduction (as defined in section 63 (c)) for an individual to whom section 63 (c)(2)(C) [1] applies, and

(B) the exemption amount (as defined in section 151 (d)).

(3) Annualized tax

For purposes of paragraph (1), the term "annualized tax" means, with respect to any payment, the amount of tax which would be imposed by section 1 (c) (determined without regard to any rate of tax in excess of the fourth lowest rate of tax applicable under section 1 (c)) on an amount of taxable income equal to the excess of—

(A) the annualized amount of such payment, over

(B) the amount determined under paragraph (2).

(4) Classes of gaming activities, etc.

For purposes of this subsection, terms used in paragraph (1) which are defined in section 4 of the Indian Gaming Regulatory Act (25 U.S.C. 2701 et seq.), as in effect on the date of the enactment of this

subsection, shall have the respective meanings given such terms by such section.

(5) Annualization

Payments shall be placed on an annualized basis under regulations prescribed by the Secretary.

(6) Alternate withholding procedures

At the election of an Indian tribe, the tax imposed by this subsection on any payment made by such tribe shall be determined in accordance with such tables or computational procedures as may be specified in regulations prescribed by the Secretary (in lieu of in accordance with paragraphs (2) and (3)).

(7) Coordination with other sections

For purposes of this chapter and so much of subtitle F as relates to this chapter, payments to any person which are subject to withholding under this subsection shall be treated as if they were wages paid by an employer to an employee.

(s) Exemption from withholding for any vehicle fringe benefit

(1) Employer election not to withhold

The employer may elect not to deduct and withhold any tax under this chapter with respect to any vehicle fringe benefit provided to any employee if such employee is notified by the employer of such election (at such time and in such manner as the Secretary shall by regulations prescribe). The preceding sentence shall not apply to any vehicle fringe benefit unless the amount of such benefit is included by the employer on a statement timely furnished under section 6051.

(2) Employer must furnish W–2

Any vehicle fringe benefit shall be treated as wages from which amounts are required to be deducted and withheld under this chapter for purposes of section 6051.

(3) Vehicle fringe benefit

For purposes of this subsection, the term "vehicle fringe benefit" means any fringe benefit—

(A) which constitutes wages (as defined in section 3401), and

(B) which consists of providing a highway motor vehicle for the use of the employee.

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[1] See References in Text note below.

Prev | Next

Sec. 3402. - Income tax collected at source

(a) Requirement of withholding

(1) In general

Except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. Any tables or procedures prescribed under this paragraph shall -

(A)

apply with respect to the amount of wages paid during such periods as the Secretary may prescribe, and

(B)

be in such form, and provide for such amounts to be deducted and withheld, as the Secretary determines to be most appropriate to carry out the purposes of this chapter and to reflect the provisions of chapter 1 applicable to such periods.

(2) Amount of wages

For purposes of applying tables or procedures prescribed under paragraph (1), the term ''the amount of wages'' means the amount by which the wages exceed the number of withholding exemptions claimed multiplied by the amount of one such exemption. The amount of each withholding exemption shall be equal to the amount of one personal exemption provided in section 151(b), prorated to the payroll period. The maximum number of withholding exemptions permitted shall be calculated in accordance with regulations prescribed by the Secretary under this section, taking into account any reduction in withholding to which an employee is entitled under this

section.

(b) Percentage method of withholding

(1)

If wages are paid with respect to a period which is not a payroll period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(2)

In any case in which wages are paid by an employer without regard to any payroll period or other period, the withholding exemption allowable with respect to each payment of such wages shall be the exemption allowed for a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(3)

In any case in which the period, or the time described in paragraph (2), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer to compute the tax to be deducted and withheld as if the aggregate of the wages paid to the employee during the calendar week were paid for a weekly payroll period.

(4)

In determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(c) Wage bracket withholding

(1)

At the election of the employer with respect to any employee, the employer shall deduct and withhold upon the wages paid to such employee a tax (in lieu of the tax required to be deducted and withheld under subsection

(a)) determined in accordance with tables prescribed by the Secretary in accordance with paragraph (6).

(2)

If wages are paid with respect to a period which is not a payroll period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days (including Sundays and holidays) equal to the number of days in the period with respect to which such wages are paid.

(3)

In any case in which wages are paid by an employer without regard to any payroll period or other period, the amount to be deducted and withheld shall be that applicable in the case of a miscellaneous payroll period containing a number of days equal to the number of days (including Sundays and holidays) which have elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during such year, or January 1 of such year, whichever is the later.

(4)

In any case in which the period, or the time described in paragraph (3), in respect of any wages is less than one week, the Secretary, under regulations prescribed by him, may authorize an employer to determine the amount to be deducted and withheld under the tables applicable in the case of a weekly payroll period, in which case the aggregate of the wages paid to the employee during the calendar week shall be considered the weekly wages.

(5)

If the wages exceed the highest wage bracket, in determining the amount to be deducted and withheld under this subsection, the wages may, at the election of the employer, be computed to the nearest dollar.

(6)

In the case of wages paid after December 31, 1969, the amount deducted and withheld under paragraph (1) shall be determined in accordance with tables prescribed by the Secretary. In the tables so prescribed, the amounts set forth as amounts of wages and amounts of income tax to be deducted and withheld shall be computed on the basis of the table for an annual payroll

period prescribed pursuant to subsection (a).

(d) Tax paid by recipient

If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer; but this subsection shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

(e) Included and excluded wages

If the remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by such employer to such employee for such period shall be deemed to be wages; but if the remuneration paid by an employer to an employee for services performed during more than one-half of any such payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed to be wages.

(f) Withholding exemptions

(1) In general

An employee receiving wages shall on any day be entitled to the following withholding exemptions:

(A)

an exemption for himself unless he is an individual described in section 151(d)(2);

(B)

if the employee is married, any exemption to which his spouse is entitled, or would be entitled if such spouse were an employee receiving wages, under subparagraph (A) or (D), but only if such spouse does not have in effect a withholding exemption certificate claiming such exemption;

(C)

an exemption for each individual with respect to whom, on the basis of facts existing at the beginning of such day, there may reasonably be expected to be allowable an exemption under section 151(c) for the taxable year under subtitle A in respect of which

amounts deducted and withheld under this chapter in the calendar year in which such day falls are allowed as a credit;

(D)

any allowance to which he is entitled under subsection (m), but only if his spouse does not have in effect a withholding exemption certificate claiming such allowance; and

(E)

a standard deduction allowance which shall be an amount equal to one exemption (or more than one exemption if so prescribed by the Secretary) unless

(i)

he is married (as determined under section 7703) and his spouse is an employee receiving wages subject to withholding or

(ii)

he has withholding exemption certificates in effect with respect to more than one employer.

For purposes of this title, any standard deduction allowance under subparagraph (E) shall be treated as if it were denominated a withholding exemption.

(2) Exemption certificates

(A) On commencement of employment

On or before the date of the commencement of employment with an employer, the employee shall furnish the employer with a signed withholding exemption certificate relating to the number of withholding exemptions which he claims, which shall in no event exceed the number to which he is entitled.

(B) Change of status

If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is less than the number of withholding exemptions claimed by the employee on the withholding exemption certificate then in effect with respect to him, the employee shall within 10 days thereafter furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the

employee then claims, which shall in no event exceed the number to which he is entitled on such day. If, on any day during the calendar year, the number of withholding exemptions to which the employee is entitled is greater than the number of withholding exemptions claimed, the employee may furnish the employer with a new withholding exemption certificate relating to the number of withholding exemptions which the employee then claims, which shall in no event exceed the number to which he is entitled on such day.

(C) Change of status which affects next calendar year

If on any day during the calendar year the number of withholding exemptions to which the employee will be, or may reasonably be expected to be, entitled at the beginning of his next taxable year under subtitle A is different from the number to which the employee is entitled on such day, the employee shall, in such cases and at such times as the Secretary may by regulations prescribe, furnish the employer with a withholding exemption certificate relating to the number of withholding exemptions which he claims with respect to such next taxable year, which shall in no event exceed the number to which he will be, or may reasonably be expected to be, so entitled.

(3) When certificate takes effect

(A) First certificate furnished

A withholding exemption certificate furnished the employer in cases in which no previous such certificate is in effect shall take effect as of the beginning of the first payroll period ending, or the first payment of wages made without regard to a payroll period, on or after the date on which such certificate is so furnished.

(B) Furnished to take place of existing certificate

(i) In general

Except as provided in clauses (ii) and (iii), a withholding exemption certificate furnished to the employer in cases in which a previous such certificate is in effect shall take effect as of the beginning of the 1st payroll period ending (or the 1st payment of wages made without regard to a payroll period) on or after the 30th day after the day on which such certificate is so furnished.

(ii) Employer may elect earlier effective date

At the election of the employer, a certificate described in clause (i) may be made effective beginning with any payment of wages made on or after the day on which the certificate is so furnished and before the 30th day referred to in clause (i).

(iii) Change of status which affects next year

Any certificate furnished pursuant to paragraph (2)(C) shall not take effect, and may not be made effective, with respect to any payment of wages made in the calendar year in which the certificate is furnished.

(4) Period during which certificate remains in effect

A withholding exemption certificate which takes effect under this subsection, or which on December 31, 1954, was in effect under the corresponding subsection of prior law, shall continue in effect with respect to the employer until another such certificate takes effect under this subsection.

(5) Form and contents of certificate

Withholding exemption certificates shall be in such form and contain such information as the Secretary may by regulations prescribe.

(6) Exemption of certain nonresident aliens

Notwithstanding the provisions of paragraph (1), a nonresident alien individual (other than an individual described in section 3401(a)(6)(A) or (B)) shall be entitled to only one withholding exemption.

(7) Exemption where certificate with another employer is in effect

If a withholding exemption certificate is in effect with respect to one employer, an employee shall not be entitled under a certificate in effect with any other employer to any withholding exemption which he has claimed under such first certificate.

(g) Overlapping pay periods, and payment by agent or fiduciary

If a payment of wages is made to an employee by an employer -

(1)

with respect to a payroll period or other period, any part of which is included in a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(2)

without regard to any payroll period or other period, but on or prior to the expiration of a payroll period or other period with respect to which wages are also paid to such employee by such employer, or

(3)

with respect to a period beginning in one and ending in another calendar year, or

(4)

through an agent, fiduciary, or other person who also has the control, receipt, custody, or disposal of, or pays, the wages payable by another employer to such employee,

the manner of withholding and the amount to be deducted and withheld under this chapter shall be determined in accordance with regulations prescribed by the Secretary under which the withholding exemption allowed to the employee in any calendar year shall approximate the withholding exemption allowable with respect to an annual payroll period.

(h) Alternative methods of computing amount to be withheld

The Secretary may, under regulations prescribed by him, authorize -

(1) Withholding on basis of average wages

An employer -

(A)

to estimate the wages which will be paid to any employee in any quarter of the calendar year,

(B)

to determine the amount to be deducted and withheld upon each payment of wages to such employee during such quarter as if the appropriate average of the wages so estimated constituted the actual wages paid, and

(C)

to deduct and withhold upon any payment of wages to such employee during such quarter (and, in the case of tips referred to in subsection (k), within 30 days thereafter) such amount as may be necessary to adjust the amount actually deducted and withheld upon the wages of such employee during such quarter to the amount required to be deducted and withheld during such quarter without regard to this subsection.

(2) Withholding on basis of annualized wages

An employer to determine the amount of tax to be deducted and withheld upon a payment of wages to an employee for a payroll period by -

(A)

multiplying the amount of an employee's wages for a payroll period by the number of such payroll periods in the calendar year,

(B)

determining the amount of tax which would be required to be deducted and withheld upon the amount determined under subparagraph (A) if such amount constituted the actual wages for the calendar year and the payroll period of the employee were an annual payroll period, and

(C)

dividing the amount of tax determined under subparagraph (B) by the number of payroll periods (described in subparagraph (A)) in the calendar year.

(3) Withholding on basis of cumulative wages

An employer, in the case of any employee who requests to have the amount of tax to be withheld from his wages computed on the basis of his cumulative wages, to -

(A)

add the amount of the wages to be paid to the employee for the payroll period to the total amount of wages paid by the employer to the employee during the calendar year,

(B)

divide the aggregate amount of wages computed

under subparagraph (A) by the number of payroll periods to which such aggregate amount of wages relates,

(C)

compute the total amount of tax that would have been required to be deducted and withheld under subsection (a) if the average amount of wages (as computed under subparagraph (B)) had been paid to the employee for the number of payroll periods to which the aggregate amount of wages (computed under subparagraph (A)) relates,

(D)

determine the excess, if any, of the amount of tax computed under subparagraph (C) over the total amount of tax deducted and withheld by the employer from wages paid to the employee during the calendar year, and

(E)

deduct and withhold upon the payment of wages (referred to in subparagraph (A)) to the employee an amount equal to the excess (if any) computed under subparagraph (D).

(4) Other methods

An employer to determine the amount of tax to be deducted and withheld upon the wages paid to an employee by any other method which will require the employer to deduct and withhold upon such wages substantially the same amount as would be required to be deducted and withheld by applying subsection (a) or (c), either with respect to a payroll period or with respect to the entire taxable year.

(i) Changes in withholding

(1) In general

The Secretary may by regulations provide for increases in the amount of withholding otherwise required under this section in cases where the employee requests such changes.

(2) Treatment as tax

Any increased withholding under paragraph (1) shall for all purposes be considered tax required to be deducted and withheld under this chapter.

(j) Noncash remuneration to retail commission salesman

In the case of remuneration paid in any medium other than cash for services performed by an individual as a retail salesman for a person, where the service performed by such individual for such person is ordinarily performed for remuneration solely by way of cash commission an employer shall not be required to deduct or withhold any tax under this subchapter with respect to such remuneration, provided that such employer files with the Secretary such information with respect to such remuneration as the Secretary may by regulation prescribe.

(k) Tips

In the case of tips which constitute wages, subsection (a) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a), and only to the extent that the tax can be deducted and withheld by the employer, at or after the time such statement is so furnished and before the close of the calendar year in which such statement is furnished, from such wages of the employee (excluding tips, but including funds turned over by the employee to the employer for the purpose of such deduction and withholding) as are under the control of the employer; and an employer who is furnished by an employee a written statement of tips (received in a calendar month) pursuant to section 6053(a) to which paragraph (16)(B) of section 3401(a) is applicable may deduct and withhold the tax with respect to such tips from any wages of the employee (excluding tips) under his control, even though at the time such statement is furnished the total amount of the tips included in statements furnished to the employer as having been received by the employee in such calendar month in the course of his employment by such employer is less than $20. Such tax shall not at any time be deducted and withheld in an amount which exceeds the aggregate of such wages and funds (including funds turned over under section 3102(c)(2) or section 3202(c)(2)) minus any tax required by section 3102(a) or section 3202 (a) to be collected from such wages and funds.

(l) Determination and disclosure of marital status

(1) Determination of status by employer

For purposes of applying the tables in subsections (a) and (c) to a payment of wages, the employer shall treat the employee as a single person unless there is in effect with respect to such payment of wages a withholding exemption certificate furnished to the employer by the employee after the date of the enactment of this subsection indicating that the employee is married.

(2) Disclosure of status by employee

An employee shall be entitled to furnish the employer with a withholding exemption certificate indicating he is married only if, on the day of such furnishing, he is married (determined with the application of the rules in paragraph (3)). An employee whose marital status changes from married to single shall, at such time as the Secretary may by regulations prescribe, furnish the employer with a new withholding exemption certificate.

(3) Determination of marital status

For purposes of paragraph (2), an employee shall on any day be considered -

(A)

as not married, if

(i)

he is legally separated from his spouse under a decree of divorce or separate maintenance, or

(ii)

either he or his spouse is, or on any preceding day within the calendar year was, a nonresident alien; or

(B)

as married, if

(i)

his spouse (other than a spouse referred to in subparagraph (A)) died within the portion of his taxable year which precedes such day, or

(ii)

his spouse died during one of the two taxable years immediately preceding the current taxable year and, on the basis of facts existing at the beginning of such day, the employee reasonably expects, at the close of his taxable year, to be a surviving spouse (as defined in section 2(a)).

(m) Withholding allowances

Under regulations prescribed by the Secretary, an employee shall be entitled to additional withholding allowances or additional reductions in withholding under this

subsection. In determining the number of additional withholding allowances or the amount of additional reductions in withholding under this subsection, the employee may take into account (to the extent and in the manner provided by such regulations) -

(1)

estimated itemized deductions allowable under chapter 1 (other than the deductions referred to in section 151 and other than the deductions required to be taken into account in determining adjusted gross income under section 62(a) (other than paragraph (10) thereof)),

(2)

estimated tax credits allowable under chapter 1, and

(3)

such additional deductions (including the additional standard deduction under section 63(c)(3) for the aged and blind) and other items as may be specified by the Secretary in regulations.

(n) Employees incurring no income tax liability

Notwithstanding any other provision of this section, an employer shall not be required to deduct and withhold any tax under this chapter upon a payment of wages to an employee if there is in effect with respect to such payment a withholding exemption certificate (in such form and containing such other information as the Secretary may prescribe) furnished to the employer by the employee certifying that the employee -

(1)

incurred no liability for income tax imposed under subtitle A for his preceding taxable year, and

(2)

anticipates that he will incur no liability for income tax imposed under subtitle A for his current taxable year.

The Secretary shall by regulations provide for the coordination of the provisions of this subsection with the provisions of subsection (f).

(o) Extension of withholding to certain payments other than wages

(1) General rule

For purposes of this chapter (and so much of subtitle F as relates to this chapter) -

(A)

any supplemental unemployment compensation benefit paid to an individual,

(B)

any payment of an annuity to an individual, if at the time the payment is made a request that such annuity be subject to withholding under this chapter is in effect, and

(C)

any payment to an individual of sick pay which does not constitute wages (determined without regard to this subsection), if at the time the payment is made a request that such sick pay be subject to withholding under this chapter is in effect,

shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.

(2) Definitions

(A) Supplemental unemployment compensation benefits

For purposes of paragraph (1), the term ''supplemental unemployment compensation benefits'' means amounts which are paid to an employee, pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

(B) Annuity

For purposes of this subsection, the term ''annuity'' means any amount paid to an individual as a pension or annuity.

(C) Sick pay

For purposes of this subsection, the term ''sick pay'' means any amount which -

(i)

is paid to an employee pursuant to a plan to which the employer is a party, and

(ii)

constitutes remuneration or a payment in lieu of remuneration for any period during which the employee is temporarily absent from work on account of sickness or personal injuries.

(3) Amount withheld from annuity payments or sick pay

If a payee makes a request that an annuity or any sick pay be subject to withholding under this chapter, the amount to be deducted and withheld under this chapter from any payment to which such request applies shall be an amount (not less than a minimum amount determined under regulations prescribed by the Secretary) specified by the payee in such request. The amount deducted and withheld with respect to a payment which is greater or less than a full payment shall bear the same relation to the specified amount as such payment bears to a full payment.

(4) Request for withholding

A request that an annuity or any sick pay be subject to withholding under this chapter -

(A)

shall be made by the payee in writing to the person making the payments and shall contain the social security number of the payee,

(B)

shall specify the amount to be deducted and withheld from each full payment, and

(C)

shall take effect -

(i)

in the case of sick pay, with respect to payments made more than 7 days after the date on which such request is furnished to the payor, or

(ii)

in the case of an annuity, at such time (after the date on which such request is furnished to the

payor) as the Secretary shall by regulations prescribe.

Such a request may be changed or terminated by furnishing to the person making the payments a written statement of change or termination which shall take effect in the same manner as provided in subparagraph (C). At the election of the payor, any such request (or statement of change or revocation) may take effect earlier than as provided in subparagraph (C).

(5) Special rule for sick pay paid pursuant to certain collective-bargaining agreements

In the case of any sick pay paid pursuant to a collective-bargaining agreement between employee representatives and one or more employers which contains a provision specifying that this paragraph is to apply to sick pay paid pursuant to such agreement and contains a provision for determining the amount to be deducted and withheld from each payment of such sick pay -

(A)

the requirement of paragraph (1)(C) that a request for withholding be in effect shall not apply, and

(B)

except as provided in subsection (n), the amounts to be deducted and withheld under this chapter shall be determined in accordance with such agreement.

The preceding sentence shall not apply with respect to sick pay paid pursuant to any agreement to any individual unless the social security number of such individual is furnished to the payor and the payor is furnished with such information as is necessary to determine whether the payment is pursuant to the agreement and to determine the amount to be deducted and withheld.

(6) Coordination with withholding on designated distributions under section 3405

This subsection shall not apply to any amount which is a designated distribution (within the meaning of section 3405(e)(1)).

(p) Voluntary withholding agreements

(1) Certain Federal payments

(A) In general

If, at the time a specified Federal payment is made to any person, a request by such person is in effect that such payment be subject to withholding under this chapter, then for purposes of this chapter and so much of subtitle F as relates to this chapter, such payment shall be treated as if it were a payment of wages by an employer to an employee.

(B) Amount withheld

The amount to be deducted and withheld under this chapter from any payment to which any request under subparagraph (A) applies shall be an amount equal to the percentage of such payment specified in such request. Such a request shall apply to any payment only if the percentage specified is 7, 15, 28, or 31 percent or such other percentage as is permitted under regulations prescribed by the Secretary.

(C) Specified Federal payments

For purposes of this paragraph, the term ''specified Federal payment'' means -

(i)

any payment of a social security benefit (as defined in section 86(d)),

(ii)

any payment referred to in the second sentence of section 451(d) which is treated as insurance proceeds,

(iii)

any amount which is includible in gross income under section 77(a), and

(iv)

any other payment made pursuant to Federal law which is specified by the Secretary for purposes of this paragraph.

(D) Requests for withholding

Rules similar to the rules that apply to annuities under subsection (o)(4) shall apply to requests under this paragraph and paragraph (2).

(2) Voluntary withholding on unemployment benefits

If, at the time a payment of unemployment compensation (as defined in section 85(b)) is made to any person, a request by such person is in effect that such payment be subject to withholding under this chapter, then for purposes of this chapter and so much of subtitle F as relates to this chapter, such payment shall be treated as if it were a payment of wages by an employer to an employee. The amount to be deducted and withheld under this chapter from any payment to which any request under this paragraph applies shall be an amount equal to 15 percent of such payment.

(3) Authority for other voluntary withholding

The Secretary is authorized by regulations to provide for withholding -

(A)

from remuneration for services performed by an employee for the employee's employer which (without regard to this paragraph) does not constitute wages, and

(B)

from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter,

if the employer and employee, or the person making and the person receiving such other type of payment, agree to such withholding. Such agreement shall be in such form and manner as the Secretary may by regulations prescribe. For purposes of this chapter (and so much of subtitle F as relates to this chapter), remuneration or other payments with respect to which such agreement is made shall be treated as if they were wages paid by an employer to an employee to the extent that such remuneration is paid or other payments are made during the period for which the agreement is in effect.

(q) Extension of withholding to certain gambling winnings

(1) General rule

Every person, including the Government of the United States, a State, or a political subdivision thereof, or any instrumentalities of the foregoing, making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in an amount

equal to 28 percent of such payment.

(2) Exemption where tax otherwise withheld

In the case of any payment of winnings which are subject to withholding made to a nonresident alien individual or a foreign corporation, the tax imposed under paragraph (1) shall not apply to any such payment subject to tax under section 1441(a) (relating to withholding on nonresident aliens) or tax under section 1442(a) (relating to withholding on foreign corporations).

(3) Winnings which are subject to withholding

For purposes of this subsection, the term ''winnings which are subject to withholding'' means proceeds from a wager determined in accordance with the following:

(A) In general

Except as provided in subparagraphs (B) and (C), proceeds of more than $5,000 from a wagering transaction, if the amount of such proceeds is at least 300 times as large as the amount wagered.

(B) State-conducted lotteries

Proceeds of more than $5,000 from a wager placed in a lottery conducted by an agency of a State acting under authority of State law, but only if such wager is placed with the State agency conducting such lottery, or with its authorized employees or agents.

(C) Sweepstakes, wagering pools, certain parimutuel pools, jai alai, and lotteries

Proceeds of more than $5,000 from -

(i)

a wager placed in a sweepstakes, wagering pool, or lottery (other than a wager described in subparagraph (B)), or

(ii)

a wagering transaction in a parimutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered.

(4) Rules for determining proceeds from a wager

For purposes of this subsection -

(A)

proceeds from a wager shall be determined by reducing the amount received by the amount of the wager, and

(B)

proceeds which are not money shall be taken into account at their fair market value.

(5) Exception for bingo, keno, and slot machines

The tax imposed under paragraph (1) shall not apply to winnings from a slot machine, keno, and bingo.

(6) Statement by recipient

Every person who is to receive a payment of winnings which are subject to withholding shall furnish the person making such payment a statement, made under the penalties of perjury, containing the name, address, and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment.

(7) Coordination with other sections

For purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to this chapter, payments to any person of winnings which are subject to withholding shall be treated as if they were wages paid by an employer to an employee.

(r) Extension of withholding to certain taxable payments of Indian casino profits

(1) In general

Every person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenues of any class II or class III gaming activity conducted or licensed by such tribe shall deduct and withhold from such payment a tax in an amount equal to such payment's proportionate share of the annualized tax.

(2) Exception

The tax imposed by paragraph (1) shall not apply to any payment to the extent that the payment, when

annualized, does not exceed an amount equal to the sum of -

(A)

the basic standard deduction (as defined in section 63(c)) for an individual to whom section 63(c)(2)(C) applies, and

(B)

the exemption amount (as defined in section 151 (d)).

(3) Annualized tax

For purposes of paragraph (1), the term ''annualized tax'' means, with respect to any payment, the amount of tax which would be imposed by section 1(c) (determined without regard to any rate of tax in excess of 31 percent) on an amount of taxable income equal to the excess of -

(A)

the annualized amount of such payment, over

(B)

the amount determined under paragraph (2).

(4) Classes of gaming activities, etc.

For purposes of this subsection, terms used in paragraph (1) which are defined in section 4 of the Indian Gaming Regulatory Act (25 U.S.C. 2701 et seq.), as in effect on the date of the enactment of this subsection, shall have the respective meanings given such terms by such section.

(5) Annualization

Payments shall be placed on an annualized basis under regulations prescribed by the Secretary.

(6) Alternate withholding procedures

At the election of an Indian tribe, the tax imposed by this subsection on any payment made by such tribe shall be determined in accordance with such tables or computational procedures as may be specified in regulations prescribed by the Secretary (in lieu of in accordance with paragraphs (2) and (3)).

(7) Coordination with other sections

For purposes of this chapter and so much of subtitle F as relates to this chapter, payments to any person which are subject to withholding under this subsection shall be treated as if they were wages paid by an employer to an employee.

(s) Exemption from withholding for any vehicle fringe benefit

(1) Employer election not to withhold

The employer may elect not to deduct and withhold any tax under this chapter with respect to any vehicle fringe benefit provided to any employee if such employee is notified by the employer of such election (at such time and in such manner as the Secretary shall by regulations prescribe). The preceding sentence shall not apply to any vehicle fringe benefit unless the amount of such benefit is included by the employer on a statement timely furnished under section 6051.

(2) Employer must furnish W-2

Any vehicle fringe benefit shall be treated as wages from which amounts are required to be deducted and withheld under this chapter for purposes of section 6051.

(3) Vehicle fringe benefit

For purposes of this subsection, the term ''vehicle fringe benefit'' means any fringe benefit -

(A)

which constitutes wages (as defined in section 3401), and

(B)

which consists of providing a highway motor vehicle for the use of the employee

Prev | Next

§ 3403. Liability for tax

How Current is This?

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.

Search this title:

Search Title 26

Notes
Updates
Parallel regulations (CFR)
Your comments

Prev | Next

Sec. 3403. - Liability for tax

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment

§ 3501. Collection and payment of taxes

How Current is This?

(a) General rule

The taxes imposed by this subtitle shall be collected by the Secretary and shall be paid into the Treasury of the United States as internal-revenue collections.

(b) Taxes with respect to non-cash fringe benefits

The taxes imposed by this subtitle with respect to non-cash fringe benefits shall be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations.

Search this title:

Search Title 26

Notes
Updates
Parallel regulations (CFR)
Your comments

Prev | Next

Sec. 3501. - Collection and payment of taxes

(a) General rule

The taxes imposed by this subtitle shall be collected by the Secretary and shall be paid into the Treasury of the United States as internal-revenue collections.

(b) Taxes with respect to non-cash fringe benefits

The taxes imposed by this subtitle with respect to non-cash fringe benefits shall be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations

§ 31. Tax withheld on wages

How Current is This?

(a) Wage withholding for income tax purposes

(1) In general

The amount withheld as tax under chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) Year of credit

The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

(b) Credit for special refunds of social security tax

(1) In general

The Secretary may prescribe regulations providing for the crediting against the tax imposed by this subtitle of the amount determined by the taxpayer or the Secretary to be allowable under section 6413 (c) as a special refund of tax imposed on wages. The amount allowed as a credit under such regulations shall, for purposes of this subtitle, be considered an amount withheld at source as tax under section 3402.

(2) Year of credit

Any amount to which paragraph (1) applies shall be allowed as a credit for the taxable year beginning in the calendar year during which the wages were received. If more than one taxable year begins in the calendar year, such amount shall be allowed as a credit for the last

taxable year so beginning.

(c) Special rule for backup withholding

Any credit allowed by subsection (a) for any amount withheld under section 3406 shall be allowed for the taxable year of the recipient of the income in which the income is received.

Prev | Next

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26 U.S.C.A. § 1 **This document has been updated. Use KEYCITE.**

I.R.C. § 1

UNITED STATES CODE ANNOTATED

TITLE 26. INTERNAL REVENUE CODE

SUBTITLE A--INCOME TAXES

CHAPTER 1--NORMAL TAXES AND SURTAXES

SUBCHAPTER A--DETERMINATION OF TAX LIABILITY

PART I--TAX ON INDIVIDUALS

Current through P.L. 107-11, approved 5-28-01

§ 1. Tax imposed

(a) [FN1] Married individuals filing joint returns and surviving spouses.**--There is hereby imposed on the taxable income of--**

(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

(2) every surviving spouse (as defined in section 2(a)), a tax determined in accordance with the following table:

If taxable income is: The tax is:

Not over $36,900 ..... 15% of taxable income.

Over $36,900 but not over

$89,150 ..... $5,535, plus 28% of the excess over $36,900.

Over $89,150 but not over

$140,000 ..... $20,165, plus 31% of the excess over $89,150.

Over $140,000 but not over

$250,000 ..... $35,928.50, plus 36% of the excess over

$140,000.

Over $250,000 ..... $75,528.50, plus 39.6% of the excess over

$250,000.

(b) [FN1] Heads of households.--There is hereby imposed on the taxable income of every head of a household (as defined in section 2(b)) a tax determined in accordance with the following table:

If taxable income is: The tax is:

Not over $29,600 ..... 15% of taxable income.

Over $29,600 but not over

$76,400 ..... $4,440, plus 28% of the excess over $29,600.

Over $76,400 but not over

$127,500 ..... $17,544, plus 31% of the excess over $76,400.

Over $127,500 but not over

$250,000..... $33,385, plus 36% of the excess over

$127,500.

Over $250,000 ..... $77,485, plus 39.6% of the excess over

$250,000.

(c) [FN1] Unmarried individuals (other than surviving spouses and heads of households).**--There is hereby imposed on the taxable income of every** individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:

If taxable income is: The tax is:

Not over $22,100 ..... 15% of taxable income.

Over $22,100 but not over

$53,500 ..... $3,315, plus 28% of the excess over $22,100.

Over $53,500 but not over

$115,000 ..... $12,107, plus 31% of the excess over $53,500.

Over $115,000 but not over

$250,000 ..... $31,172, plus 36% of the excess over $115,000.

Over $250,000 ..... $79,772, plus 39.6% of the excess over

$250,000.

(d) [FN1] Married individuals filing separate returns.--There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

If taxable income is: The tax is:

Not over $18,450 ..... 15% of taxable income.

Over $18,450 but not over

$44,575 ..... $2,767.50, plus 28% of the excess over $18,450.

Over $44,575 but not over

$70,000 ..... $10,082.50, plus 31% of the excess over

$44,575.

Over $70,000 but not over

$125,000 ..... $17,964.25, plus 36% of the excess over

$70,000.

Over $125,000 ..... $37,764.25, plus 39.6% of the excess over

$125,000.

(e) [FN1] Estates and trusts.--There is hereby imposed on the taxable income of--

(1) every estate, and

(2) every trust,

taxable under this subsection a tax determined in accordance with the following table:

If taxable income is: The tax is:

Not over $1,500 ..... 15% of taxable income.

Over $1,500 but not over $3,500 . $225, plus 28% of the excess over $1,500.

Over $3,500 but not over $5,500 . $785, plus 31% of the excess over $3,500.

Over $5,500 but not over $7,500 . $1,405, plus 36% of the excess over $5,500.

Over $7,500 ..... $2,125, plus 39.6% of the excess over $7,500.

(f) Adjustments in tax tables so that inflation will not result in tax increases.--

(1) In general.--Not later than December 15 of 1993, and each subsequent calendar year, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in subsections (a), (b), (c), (d), and (e) with respect to taxable years beginning in the succeeding calendar year.

(2) Method of prescribing tables.--The table which under paragraph (1) is to apply in lieu of the table contained in subsection (a), (b), (c), (d), or (e), as the case may be, with respect to taxable years beginning in any calendar year shall be prescribed--

(A) by increasing the minimum and maximum dollar amounts for each rate bracket for which a tax is imposed under such table by the cost-of-living adjustment for such calendar year,

(B) by not changing the rate applicable to any rate bracket as adjusted under subparagraph (A), and

(C) by adjusting the amounts setting forth the tax to the extent necessary to reflect the adjustments in the rate brackets.

(3) Cost-of-living adjustment.--For purposes of paragraph (2), the cost-of- living adjustment for any calendar year is the percentage (if any) by which--

(A) the CPI for the preceding calendar year, exceeds

(B) the CPI for the calendar year 1992.

(4) CPI for any calendar year.--For purposes of paragraph (3), the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on August 31 of such calendar year.

(5) Consumer price index.--For purposes of paragraph (4), the term "Consumer Price Index" means the last Consumer Price Index for all-urban consumers published by the Department of Labor. For purposes of the preceding sentence, the revision of the Consumer Price Index which is most consistent with the Consumer Price Index for calendar year 1986 shall be used.

(6) Rounding.--

(A) In general.--If any increase determined under paragraph (2)(A), section 63(c)(4), section 68(b)(2) or section 151(d)(4) is not a multiple of $50, such increase shall be rounded to the next lowest multiple of $50.

(B) Table for married individuals filing separately.--In the case of a married individual filing a separate return, subparagraph (A) (other than with respect to subsection (c)(4) of section 63 (as it applies to subsections (c)(5)(A) and (f) of such section) and section 151(d)(4)(A)) shall be applied by substituting "$25" for "$50" each place it appears.

(7) Special rule for certain brackets.--

(A) Calendar year 1994.--In prescribing the tables under paragraph (1) which apply with respect to taxable years beginning in calendar year 1994, the Secretary shall make no adjustment to the dollar amounts at which the 36 percent rate bracket begins or at which the 39.6 percent rate begins under any table contained in subsection (a), (b), (c), (d), or (e).

(B) Later calendar years.--In prescribing tables under paragraph (1) which apply with respect to taxable years beginning in a calendar year after 1994, the cost-of-living adjustment used in making adjustments to the dollar amounts referred to in subparagraph (A) shall be determined under paragraph (3) by substituting "1993" for "1992".

(g) Certain unearned income of minor children taxed as if parent's income.--

(1) In general.--In the case of any child to whom this subsection applies, the tax imposed by this section shall be equal to the greater of--

(A) the tax imposed by this section without regard to this subsection, or

(B) the sum of--

(i) the tax which would be imposed by this section if the taxable income of such child for the taxable year were reduced by the net unearned income of such child, plus

(ii) such child's share of the allocable parental tax.

(2) Child to whom subsection applies.--This subsection shall apply to any child for any taxable year if--

(A) such child has not attained age 14 before the close of the taxable year, and

(B) either parent of such child is alive at the close of the taxable year.

(3) Allocable parental tax.--For purposes of this subsection--

(A) In general.--The term "allocable parental tax" means the excess of--

(i) the tax which would be imposed by this section on the parent's taxable income if such income included the net unearned income of all children of the parent to whom this subsection applies, over

(ii) the tax imposed by this section on the parent without regard to this subsection.

For purposes of clause (i), net unearned income of all children of the parent shall not be taken into account in computing any exclusion, deduction, or credit of the parent.

(B) Child's share.--A child's share of any allocable parental tax of a parent shall be equal to an amount which bears the same ratio to the total allocable parental tax as the child's net unearned income bears to the aggregate net unearned income of all children of such parent to whom this subsection applies.

(C) Special rule where parent has different taxable year.--Except as provided in regulations, if the parent does not have the same taxable year as the child, the allocable parental tax shall be determined on the basis of the taxable year of the parent ending in the child's taxable year.

[(D) Redesignated (C)]

(4) Net unearned income.--For purposes of this subsection--

(A) In general.--The term "net unearned income" means the excess of--

(i) the portion of the adjusted gross income for the taxable year which is not attributable to earned income (as defined in section 911(d)(2)), over

(ii) the sum of--

(I) the amount in effect for the taxable year under section 63(c)(5)(A) (relating to limitation on standard deduction in the case of certain dependents), plus

(II) the greater of the amount described in subclause (I) or, if the child itemizes his deductions for the taxable year, the amount of the itemized deductions allowed by this chapter for the taxable year which are directly connected with the production of the portion of adjusted gross income referred to in clause (i).

(B) Limitation based on taxable income.--The amount of the net unearned income for any taxable year shall not exceed the individual's taxable income for such taxable year.

(5) Special rules for determining parent to whom subsection applies.--For purposes of this subsection, the parent whose taxable income shall be taken into account shall be--

(A) in the case of parents who are not married (within the meaning of section 7703), the custodial parent (within the meaning of section 152(e)) of the child, and

(B) in the case of married individuals filing separately, the individual with the greater taxable income.

(6) Providing of parent's TIN.--The parent of any child to whom this subsection applies for any taxable year shall provide the TIN of such parent to such child and such child shall include such TIN on the child's return of tax imposed by this section for such taxable year.

(7) Election to claim certain unearned income of child on parent's return.--

(A) In general.--If--

(i) any child to whom this subsection applies has gross income for the taxable year only from interest and dividends (including Alaska Permanent Fund dividends),

(ii) such gross income is more than the amount described in paragraph (4)(A)(ii)(I) and less than 10 times the amount so described,

(iii) no estimated tax payments for such year are made in the name and TIN of such child, and no amount has been deducted and withheld under section 3406, and

(iv) the parent of such child (as determined under paragraph (5)) elects the application of subparagraph (B),

such child shall be treated (other than for purposes of this paragraph) as having no gross income for such year and shall not be required to file a return under section 6012.

(B) Income included on parent's return.--In the case of a parent making the election under this paragraph--

(i) the gross income of each child to whom such election applies (to the extent the gross income of such child exceeds twice the amount described in paragraph (4)(A)(ii)(I)) shall be included in such parent's gross income for the taxable year,

(ii) the tax imposed by this section for such year with respect to such parent shall be the amount equal to the sum of--

(I) the amount determined under this section after the application of clause (i), plus

(II) for each such child, 15 percent of the lesser of the amount described in paragraph (4)(A)(ii)(I) or the excess of the gross income of such child over the amount so described, and

(iii) any interest which is an item of tax preference under section 57(a)(5) of the child shall be treated as an item of tax preference of such parent (and not of such child).

(C) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph.

(h) Maximum capital gains rate.--

(1) In general.--If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of--

(A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of--

(i) taxable income reduced by the net capital gain; or

(ii) the lesser of--

(I) the amount of taxable income taxed at a rate below 28 percent; or

(II) taxable income reduced by the adjusted net capital gain;

(B) 10 percent of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of--

(i) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 28 percent, over

(ii) the taxable income reduced by the adjusted net capital gain;

(C) 20 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the amount on which a tax is determined under subparagraph (B);

(D) 25 percent of the excess (if any) of--

(i) the unrecaptured section 1250 gain (or, if less, the net capital gain), over

(ii) the excess (if any) of--

(I) the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over

(II) taxable income; and

(E) 28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

(2) Reduced capital gain rates for qualified 5-year gain.--

(A) Reduction in 10-percent rate.--In the case of any taxable year beginning after December 31, 2000, the rate under paragraph (1)(B) shall be 8 percent with respect to so much of the amount to which the 10-

percent rate would otherwise apply as does not exceed qualified 5-year gain, and 10 percent with respect to the remainder of such amount.

(B) Reduction in 20-percent rate.--The rate under paragraph (1)(C) shall be 18 percent with respect to so much of the amount to which the 20-percent rate would otherwise apply as does not exceed the lesser of--

(i) the excess of qualified 5-year gain over the amount of such gain taken into account under subparagraph (A) of this paragraph; or

(ii) the amount of qualified 5-year gain (determined by taking into account only property the holding period for which begins after December 31, 2000),

and 20 percent with respect to the remainder of such amount. For purposes of determining under the preceding sentence whether the holding period of property begins after December 31, 2000, the holding period of property acquired pursuant to the exercise of an option (or other right or obligation to acquire property) shall include the period such option (or other right or obligation) was held.

(3) Net capital gain taken into account as investment income.--For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii).

(4) Adjusted net capital gain.--For purposes of this subsection, the term "adjusted net capital gain" means net capital gain reduced (but not below zero) by the sum of--

(A) unrecaptured section 1250 gain; and

(B) 28-percent rate gain.

(5) 28-percent rate gain.--For purposes of this subsection, the term "28- percent rate gain" means the excess (if any) of--

(A) the sum of--

(i) collectibles gain; and

(ii) section 1202 gain, over

(B) the sum of--

(i) collectibles loss;

(ii) the net short-term capital loss; and

(iii) the amount of long-term capital loss carried under section 1212(b)(1)(B) to the taxable year.

(6) Collectibles gain and loss.--For purposes of this subsection.--

(A) In general.--The terms "collectibles gain" and "collectibles loss" mean gain or loss (respectively) from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.

(B) Partnerships, etc.--For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to the rules of section 751 shall apply for purposes of the preceding sentence.

(7) Unrecaptured section 1250 gain.--For purposes of this subsection.--

(A) In general.--The term "unrecaptured section 1250 gain" means the excess (if any) of--

(i) the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, over

(ii) the excess (if any) of--

(I) the amount described in paragraph (5)(B); over

(II) the amount described in paragraph (5)(A).

(B) Limitation with respect to section 1231 property.--The amount described in subparagraph (A)(i) from sales, exchanges, and conversions described in section 1231(a)(3)(A) for any taxable year shall not exceed the net section 1231 gain (as defined in section 1231(c)(3)) for such year.

(8) Section 1202 gain.--For purposes of this subsection, the term "section 1202 gain" means the excess of--

(A) the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a), over

(B) the gain excluded from gross income under section 1202.

(9) Qualified 5-year gain.--For purposes of this subsection, the term "qualified 5-year gain" means the aggregate long-term capital gain from property held for more than 5 years. The determination under the preceding sentence shall be made without regard to collectibles gain, gain described in paragraph (7)(A)(i), and section 1202 gain.

(10) Coordination with recapture of net ordinary losses under section 1231.-- If any amount is treated as ordinary income under section 1231(c), such amount shall be allocated among the separate categories of net

section 1231 gain (as defined in section 1231(c)(3)) in such manner as the Secretary may by forms or regulations prescribe.

(11) Regulations.--The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to apply this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities.

(12) Pass-thru entity defined.--For purposes of this subsection, the term "pass-thru entity" means--

(A) a regulated investment company;

(B) a real estate investment trust;

(C) an S corporation;

(D) a partnership;

(E) an estate or trust;

(F) a common trust fund;

(G) a foreign investment company which is described in section 1246(b)(1) and for which an election is in effect under section 1247; and

(H) a qualified electing fund (as defined in section 1295).

(13) Special rules.--

(A) Determination of 28-percent rate gain.--In applying paragraph (5)--

(i) the amount determined under subparagraph (A) of paragraph (5) shall include long-term capital gain (not otherwise described in such subparagraph)--

(I) which is properly taken into account for the portion of the taxable year before May 7, 1997; or

(II) from property held not more than 18 months which is properly taken into account for the portion of the taxable year after July 28, 1997, and before January 1, 1998;

(ii) the amount determined under subparagraph (B) of paragraph (5) shall include long-term capital loss (not otherwise described in such subparagraph)--

(I) which is properly taken into account for the portion of the taxable year before May 7, 1997; or

(II) from property held not more than 18 months which is properly taken into account for the portion

of the taxable year after July 28, 1997, and before January 1, 1998; and

(iii) subparagraph (B) of paragraph (5) (as in effect immediately before the enactment of this clause) shall apply to amounts properly taken into account before January 1, 1998.

(B) Determination of unrecaptured section 1250 gain.--The amount determined under paragraph (7)(A)(i) shall not include gain--

(i) which is properly taken into account for the portion of the taxable year before May 7, 1997; or

(ii) from property held not more than 18 months which is properly taken into account for the portion of the taxable year after July 28, 1997, and before January 1, 1998.

(C) Special rules for pass-thru entities.--In applying this paragraph with respect to any pass-thru entity, the determination of when gains and loss are properly taken into account shall be made at the entity level.

(D) Charitable remainder trusts.--Subparagraphs (A) and (B)(ii) shall not apply to any capital gain distribution made by a trust described in section 664.

CREDIT(S)

2001 Electronic Update

(Aug. 16, 1954, c. 736, 68A Stat. 5; Feb. 26, 1964, Pub.L. 88-272, Title I, § 111, 78 Stat. 19; Nov. 13, 1966, Pub.L. 89-809, Title I, § 103(a)(2), 80 Stat. 1550; Dec. 30, 1969, Pub.L. 91-172, Title VIII, § 803(a), 83 Stat. 678; May 23, 1977, Pub.L. 95-30, Title I, § 101(a), 91 Stat. 127; Nov. 11, 1978, Pub.L. 95-600, Title I, § 101(a), 92 Stat. 2767; Aug. 13, 1981, Pub.L. 97-34, Title I, §§ 101(a), 104(a), 95 Stat. 176, 188; Jan. 12, 1983, Pub.L. 97-448, Title I, § 101(a)(3), 96 Stat. 2366; Oct. 22, 1986, Pub.L. 99-514, Title I, § 101(a), Title III, § 302(a), Title XIV, § 1411(a), 100 Stat. 2096, 2216, 2714; Nov. 10, 1988, Pub.L. 100-647, Title I, §§ 1001(a)(3), 1014, (e)(1) to (3), 6, 7, Title VI, § 6006(a), 102 Stat. 3349, 3561, 3562, 3686; Dec. 19, 1989,

Sec. 31. - Tax withheld on wages

(a) Wage withholding for income tax purposes

(1) In general

The amount withheld as tax under chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) Year of credit

The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

(b) Credit for special refunds of social security tax

(1) In general

The Secretary may prescribe regulations providing for the crediting against the tax imposed by this subtitle of the amount determined by the taxpayer or the Secretary to be allowable under section 6413(c) as a special refund of tax imposed on wages. The amount allowed as a credit under such regulations shall, for purposes of this subtitle, be considered an amount withheld at source as tax under section 3402.

(2) Year of credit

Any amount to which paragraph (1) applies shall be allowed as a credit for the taxable year beginning in the calendar year during which the wages were received. If more than one taxable year begins in the calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

(c) Special rule for backup withholding

Any credit allowed by subsection (a) for any amount withheld under section 3406 shall be allowed for the taxable year of the recipient of the income in which the income is received

Next

Town Hall
- Home
- What's New
- The RightPages
- About Us

Issues & Opinion
- NewsWire
- Columnists
- Issues Library
- Week In Review
- Spotlights

Interaction
- Live Chat
- Message Board
- Multimedia
- Rush Room
- Capital Cam
- Reagan's Legacy
- Hall of Fame

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February 14, 2001

A taxing situation

The debate over whether or not to cut taxes is a fascinating one because both sides have boatloads of ammunition. The across-the-board tax-cutters who favor President Bush's approach to lower all federal income tax levels point to a discriminatory system that overtaxes working people and outright punishes the wealthy. The "tax-the-rich" crowd yells back that America is becoming an oligarchy where a few wealthy people control most of the money, while the workers struggle to get by. Let's look at the facts:

Right now the Congressional Budget Office tells us that Americans are paying the highest federal tax rate in 50 years. The combination of federal income tax and the payroll (Social Security) tax shrinks take-home pay by an average of almost 34 percent, according to the Tax Foundation in Washington.

The per capita income in the United States is $29,705 dollars. Of that, 23.4 percent is taken by the feds, and 10.4 percent goes for state income tax. Remember these rates do not include sales taxes, property taxes and the like. So there is good reason why the average American is in debt. Take-home pay is being severely diminished by the government.

If every American were required to pay the same amount of tax to meet the obligations of the federal government, the figure would be about $8,000 a head. Yet today, if you make a million dollars a year, your federal tax obligation is well over $400,000 before deductions. As the rich guys never tire of telling us, the wealthiest Americans pick up most of the tax tab, therefore they should benefit the most in any across-the-board cut.

But many politicians only want targeted tax cuts that would

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help the poor and middle class. They want the rich to continue picking up the lion's share of the tax obligation.

This is somewhat disturbing if you believe in capitalism and the notion that all citizens should be treated equally. But those beliefs are declining in America. We are rapidly becoming a society that wants the government to redistribute income from those who have to those who don't have. They do this in Sweden and other countries with some success.

But there are problems with quasi-socialism because the government cannot legislate responsibility. Remember the ant story you were told as a kid? The one that said most of the ants worked feverishly during the summer storing up food for the winter, but the grasshopper slept all day. Then winter came, and the industrious ants were fat and happy, while the lazy grasshopper went hungry.

The lesson, of course, is that you have to work for your security and prosperity.

So what happens to Americans who drop out of school, become substance abusers, have children in their teens and make a variety of other mistakes that prevent them from prospering in the marketplace? Is it morally right for the government to take money from the responsible (or just plain lucky) and give it to those who couldn't make it? If you screw up your whole life, are you entitled to free stuff when you get old?

The difficulty here is that millions of Americans do work hard and make little progress. So they are in the same boat as the irresponsible, and the government can't weed them out. Social Security was set up to protect workers, who, for whatever reason, could not save any money. It is impossible to select the worthy from the unworthy when doling out government entitlements.

Thus it does fall on the rich in America to carry the tax burden. And it is not technically fair. But this country provides a framework in which some can get very wealthy and the government expects payback for the framework.

But the government's tax system is corrupt and dumb because shrewd people can dodge taxes, and everybody knows it. There's no perfect solution, but here's a fair one:

-- Immediately abolish the payroll and Medicare taxes. Institute a federal consumption tax of 2 percent for all purchases Americans make, except private medical. That revenue would cover Social Security and Medicare payments;

-- Drop all federal income tax rates. If an American earns less than $25,000, there is no tax burden;

-- If you make between $25,000 and $50,000, you pay 18 percent;

-- If you make between $50,000 and $75,000, you pay 22 percent;

-- Between $75,000 and $150,000, you pay 25 percent;

-- And if you earn above $150,000, you pay 28 percent.

Finally, there would be a tax on all corporate profits. And I mean all. No more dodges. The rate would be calibrated on the size and profitability of the company.

There would be no marriage penalty, estate taxes or all the other intrusive garbage that violates our freedoms. Americans would have more money in their pockets, and the free market would respond to increased buying power.

This is the fair way to fund America, and special interests be damned. This system would raise more than enough money if our government spent and acted responsibly. We could even impose a national lottery if former President Clinton needs more government money for his various scams.

So send this column to Mr. Bush and your Congress people. There's no reason why we can't have some fairness on taxation in America. This is it.

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Section 1. Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly

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convicted, shall exist within the United States, or any place subject to their jurisdiction.

Section 2. Congress shall have power to enforce this article by appropriate legislation.

Annotations

- **Abolition of Slavery**
- **Origin and Purpose**
- **Peonage**
- **Situations in Which the Amendment Is Inapplicable**

21ST Amendment

Federal Constitution

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American Spying

U.S. Constitution: Thirteenth Amendment

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- Peonage
- Situations in Which the Amendment Is Inapplicable

terminate without sufficient assets to pay such benefits. 29 U.S.C.A. § 1302.

Pensioner. Recipient or beneficiary of a pension plan.

Pension fund. Fund established by corporations, unions, governmental bodies, etc. to pay pension benefits to its retired workers. *See* Pension plan.

Pension plan. A plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees, or their beneficiaries, over a period of years (usually for life) after retirement. Retirement benefits are measured by, and based on, such factors as years of service and compensation received by the employees. The Employees Retirement Income Security Act (ERISA) governs plan qualification, operation, and administration, and specifically such matters as participation requirements, funding, vesting and filing and reporting with the Internal Revenue Service and Labor Department. Pension benefits under qualified plans are guaranteed by the Pension Benefit Guaranty Corporation.

A stated allowance out of the public treasury granted by government to an individual, or to his representatives, for his valuable services to the country, or in compensation for loss or damage sustained by him in the public service. Frisbie v. U. S., 157 U.S. 160, 15 S.Ct. 586, 39 L.Ed. 657.

See also Individual retirement account; Keogh Plan; Money-purchase plan; Pension trust.

Contributory pension plan. A plan funded with both employer and employee contributions.

Defined-contribution plan. Pension plan that provides benefits as determined by the accumulated contributions and the return on the fund's investment performance; the contributions are specified, but the benefits are not.

Defined pension plan. A pension plan where the employer promises specific benefits to each employee. The employer's cash contributions and pension expense are adjusted in relation to investment performance of the pension fund. Sometimes called a "fixed-benefit" pension plan.

Funded pension plan. *See* Funded.

Noncontributory plan. A pension plan where only the employer makes payments to fund the plan. *Compare Contributory pension plan, above.*

Qualified pension plan. An employer-sponsored plan that meets the requirements of I.R.C. § 401. If these requirements are met, none of the employer's contributions to the plan are taxed to the employee until distributed to him or her [§ 402]. The employer will be allowed a deduction in the year the contributions are made [§ 404].

Pension trust. Type of funded pension plan in which the employer transfers to trustees an amount sufficient to cover cost of pensions to employees who are the beneficiaries of the trust.

Penumbra doctrine. The implied powers of the federal government predicated on the Necessary and Proper Clause of the U.S.Const., Art. I, Sec. 8(18), permits one implied power to be engrafted on another implied power. Kohl v. U. S., 91 U.S. 367, 23 L.Ed. 449.

Peonage /píyənəj/. A condition of servitude (prohibited by 13th Amendment) compelling persons to perform labor in order to pay off a debt.

People. A state; as the people of the state of New York. A nation in its collective and political capacity. The aggregate or mass of the individuals who constitute the state. Loi Hoa v. Nagle, C.C.A.Cal., 13 F.2d 80, 81. In a more restricted sense, and as generally used in constitutional law, the entire body of those citizens of a state or nation who are invested with political power for political purposes. *See also* Citizen; Person.

Peppercorn. A dried berry of the black pepper. In English law, the reservation of a merely nominal rent, on a lease, was sometimes expressed by a stipulation for the payment of a peppercorn.

Per /pər/. Lat. By, through, or by means of.

Perambulation /pəræ̀mbyəléyshən/. The act or custom of walking over the boundaries of a district or piece of land, either for the purpose of determining them or of preserving evidence of them. Thus, in many parishes in England, it is the custom for the parishioners to perambulate the boundaries of the parish in rogation week in every year. Such a custom entitles them to enter any man's land and abate nuisances in their way. The custom has now largely fallen into disuse.

Perambulatione facienda, writ de /rít dìy pəræ̀mbyəlèyshiyówniy fæ̀shiyéndə/. In old English law, the name of a writ which was sued by consent of both parties when they were in doubt as to the bounds of their respective estates. It was directed to the sheriff to make perambulation, and to set the bounds and limits between them in certainty.

Per and post /pər ənd pówst/. In old English law, to come in in the *per* is to claim by or through the person last entitled to an estate; as the heirs or assigns of the grantee. To come in in the *post* is to claim by a paramount and prior title; as the lord by escheat.

Per annum /pər ǽnəm/. By the year; annually; yearly.

Per autre vie /pər ówtrə víy/°váy/. L. Fr. For or during another's life; for such period as another person shall live.

Per aversionem /pər əvə̀rz(h)iyównəm/. Lat. In the civil law, by turning away. A term applied to that kind of sale where the goods are taken in bulk, and not by weight or measure, and for a single price; or where a piece of land is sold as containing in gross, by estimation, a certain number of acres. So called because the buyer acts without particular examination or discrimination, *turning* his face, as it were, *away*.

Per bouche /pər bú(w)sh/. L. Fr. By the mouth; orally.

U.S. Constitution: Sixteenth Amendment

Sixteenth Amendment - Income Tax

Amendment Text | Annotations

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.

Annotations

- Income Tax
- History and Purpose of the Amendment
- Income Subject to Taxation
  - Corporate Dividends: When Taxable
  - Corporate Earnings: When Taxable
  - Gains: When Taxable
  - Income from Illicit Transactions
  - Deductions and Exemptions
  - Diminution of Loss

Thomas Jefferson on Politics & Government

Table of Contents

This collection contains over 2,700 quotations from the writings of Thomas Jefferson. To download the special collection of over 400 quotations, see the option at the end of the Table of Contents.

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Please refer to the Front Page for introductory information and for links to other resources related to Thomas Jefferson and his writings.

"The principles of Jefferson are the axioms of a free society." --Abraham Lincoln

I. The Fundamentals of Government

1. Inalienable Rights
2. Securing Rights
3. Moral Principles
4. Moral Degeneracy
5. The Sovereignty of the People
6. The Safest Depository

II. The Theory of Republican Government

7. Republican Principles
8. Majority Rule
9. Self-Government
10. Good Government
11. Governed by Reason
12. Difference of Opinion
13. Political Parties

III. The Structure of Republican Government

14. Constitutions: State & Federal
15. The Bill of Rights
16. Amending the Constitution
17. Interpreting the Constitution
18. Judicial Review
19. Separation of Powers: Federal and State
20. Against Consolidated Government
21. Separation of Powers: Legislative, Executive, and Judicial
22. Elective Government
23. Legislative Branch
24. The Legislators
25. Executive Branch
26. Presidential Elections
27. The Art of Governing
28. Duties of the Executive
29. Judicial Branch

IV. Government Policy in a Republic

30. The Justice System
31. Immigration Policy
32. Racial Policy
33. Native American Policy
34. Public Works & Public Assistance
35. Commerce & Agriculture
36. Money & Banking
37. Taxation & Fiscal Responsibility
38. The National Debt
39. Educating the People
40. Publicly Supported Education
41. Foreign Relations
42. The Rights of Nations
43. Foreign Commerce
44. Peace & War
45. Unavoidable Wars
46. A Republic at War
47. The Military & the Militia

V. Citizen Rights in a Republic

48. Civil Rights

Free Correspondence
Freedom of Conscience
The Right to Bear Arms
Other Rights

49. Juridical Rights

Habeas Corpus
Trial by Jury

50. Property Rights
51. Freedom of the Press
52. Freedom of Religion

VI. The Prospects for Self-Government

53. Duties of Citizens
54. The Spread of Self-Government
55. Revolution and Reformation
56. The Future of Democracy in America

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A Note on the Editing

A small number of quotations are followed by the sign, (*). This designates a quote that has been 'generalized.' In its original form, the vital principle was stated in terms of a specific application. The form stated here has words added in brackets or phrases rearranged so as to give it a general, rather than a specific and, usually, dated reading. Of course, none of this is contrary to the underlying principle as expressed by Jefferson. The purpose is to extract that principle and to make available an important point that must otherwise be omitted. When this is done, more complete bibliographical information is provided so that the reader can easily verify the precise wording and context if desired.

Both the spelling and the punctuation of the quotations have been edited to conform with modern usage. Alterations to the punctuation consist mostly of fewer commas. The practice in Jefferson's time was to set off almost every phrase with commas.

Today, commas are used to convey the structure of a sentence more precisely, and too many commas undermine that depiction of structure and make the sentences more difficult for modern readers to understand.

The designation in the form, "Papers, 1:423," is a reference to the location of the quote in *The Papers of Thomas Jefferson.* The designation in the form, "ME 12:345," refers to the location in *The Writings of Thomas Jefferson,* (Memorial Edition) Lipscomb and Bergh, editors. "FE 9:234" refers to the Ford Edition of the writings. See the section Recommended Collections and Sources for further information.

Top | Links Page | Front Page

Thomas Jefferson on Politics & Government

36. Money & Banking

Banking institutions, paper money, and paper speculation are capable of undermining the nation's stability and could be a danger in time of war. The Constitution does not empower the Congress to establish a National Bank. Rather than trust the nation's currency to private hands, the circulating medium should be restored to the nation itself to whom it belongs.

"Specie is the most perfect medium because it will preserve its own level; because, having intrinsic and universal value, it can never die in our hands, and it is the surest resource of reliance in time of war." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:430

"Paper is poverty,... it is only the ghost of money, and not money itself." --Thomas Jefferson to Edward Carrington, 1788. ME 7:36

"Experience has proved to us that a dollar of silver disappears for every dollar of paper emitted." --Thomas Jefferson to James Monroe, 1791. ME 8:208

"It is a [disputed] question, whether the circulation of paper, rather than of specie, is a good or an evil... I believe it to be one of those cases where mercantile clamor will bear down reason, until it is corrected by ruin." --Thomas Jefferson to John W. Eppes, 1813. ME 13:409

Specie as a National Resource

"In such a nation [as ours], there is one and one only resource for loans, sufficient to carry them through the expense of a war; and that will always be sufficient, and in the power of an honest government, punctual in the preservation of its faith. The fund I mean, is *the mass of circulating coin*. Everyone knows, that although not literally, it is nearly true, that every paper dollar emitted banishes a silver one from the circulation. A nation, therefore, making its purchases and payments with bills fitted for circulation, thrusts an equal sum of coin out of circulation. This is equivalent to borrowing that sum, and yet the vendor receiving payment in a medium as effectual as coin for his purchases or payments, has no claim to interest. And so the nation may continue to issue its bills as far as its wants require, and the limits of the circulation will admit... But this, the only resource which the government could command with certainty, the States have unfortunately fooled away, nay corruptly alienated to swindlers and shavers, under the cover of private banks." --Thomas Jefferson to John W. Eppes, 1813. ME 13:274

"One of three great measures necessary to insure us permanent prosperity... should insure resources of money by the suppression of all paper circulation during peace, and licensing that of the nation alone during war. The metallic medium of which we should be possessed at the commencement of a war, would be a sufficient fund for all the loans we should need through its continuance; and if the national bills issued be bottomed (as is indispensable) on pledges of specific taxes for their redemption within certain and moderate epochs, and be of proper denominations for circulation, no interest on them would be necessary or just, because they would answer to everyone the purposes of the metallic money withdrawn and replaced by them." --Thomas Jefferson to William H. Crawford, 1816. ME 15:30

"It would be best that our medium should be so proportioned to our produce, as to be on a par with that of the countries with which we trade, and whose medium is in a sound state." --Thomas Jefferson to John W. Eppes, 1813. ME 13:430

Dangers of Paper Money

"That paper money has some advantages is admitted. But that its abuses also are inevitable and, by breaking up the measure of value, makes a lottery of all private property, cannot be denied. --Thomas Jefferson to Josephus B. Stuart, 1817. ME 15:113

"The trifling economy of paper, as a cheaper medium, or its convenience for transmission, weighs nothing in opposition to the advantages of the precious metals... it is liable to be abused, has been, is, and forever will be abused, in every country in which it is permitted." --Thomas Jefferson to John W. Eppes, 1813. ME 13:430

"Scenes are now to take place as will open the eyes of credulity and of insanity itself, to the dangers of a paper medium abandoned to the discretion of avarice and of swindlers." --Thomas Jefferson to Thomas Cooper, 1814. ME 14:189

"The States should be applied to, to transfer the right of issuing circulating paper to Congress exclusively, *in perpetuum*." --Thomas Jefferson to John W. Eppes, 1813. ME 13:276

"The evils of this deluge of paper money are not to be removed until our citizens are generally and radically instructed in their cause and consequences, and silence by their authority the interested clamors and sophistry of speculating, shaving, and banking institutions. Till then, we must be content to return *quoad hoc* to the savage state, to recur to barter in the exchange of our property for want of a stable common measure of value, that now in use being less fixed than the beads and wampum of the Indian, and to deliver up our citizens, their property and their labor, passive victims to the swindling tricks of bankers and mountebankers." --Thomas Jefferson to John Adams, 1819. ME 15:185

"Private fortunes, in the present state of our circulation, are at the mercy of those self-created money lenders, and are prostrated by the floods of nominal money with which their avarice deluges us." --Thomas Jefferson to John W. Eppes, 1813. ME 13:276

"It is a cruel thought, that, when we feel ourselves standing on the firmest ground in every respect, the cursed arts of our secret enemies, combining with other causes, should effect, by depreciating our money, what the open arms of a powerful enemy could not." --Thomas Jefferson to Richard Henry Lee, 1779. ME 4:298, Papers 2:298

"I now deny [the Federal Government's] power of making paper money or anything else a legal tender." --Thomas Jefferson to John Taylor, 1798. ME 10:65

Paper Speculation

"A spirit... of gambling in our public paper has seized on too many of our citizens, and we fear it will check our commerce, arts, manufactures, and agriculture, unless stopped." --Thomas Jefferson to William Carmichael, 1791. ME 8:230

"Our public credit is good, but the abundance of paper has produced a spirit of gambling in the funds, which has laid up our ships at the wharves as too slow instruments of profit, and has even disarmed the hand of the tailor of his needle and thimble. They say the evil will cure itself. I wish it may; but I have rarely seen a gamester cured, even by the disasters of his vocation." --Thomas Jefferson to Gouverneur Morris, 1791. ME 8:241

"All the capital employed in paper speculation is barren and useless, producing, like that on a gaming table, no accession to itself, and is withdrawn from commerce and agriculture where it would have produced addition to the common mass... It nourishes in our citizens habits of vice and idleness instead of industry and morality... It has furnished effectual means of corrupting such a portion of the legislature as turns the balance between the honest voters whichever way it is directed." --Thomas Jefferson to George Washington, 1792. ME 8:344

"We are now taught to believe that legerdemain tricks upon paper can produce as solid wealth as hard labor in the earth. It is vain for common sense to urge that *nothing* can produce but *nothing*; that it is an idle dream to

believe in a philosopher's stone which is to turn everything into gold, and to redeem man from the original sentence of his Maker, 'in the sweat of his brow shall he eat his bread.'" --Thomas Jefferson to Charles Yancey, 1816. ME 14:381

The Importance of Personal Economy

"I own it to be my opinion, that good will arise from the destruction of our credit. I see nothing else which can restrain our disposition to luxury, and to the change of those manners which alone can preserve republican government. As it is impossible to prevent credit, the best way would be to cure its ill effects by giving an instantaneous recovery to the creditor. This would be reducing purchases on credit to purchases for ready money. A man would then see a prison painted on everything he wished, but had not ready money to pay for." --Thomas Jefferson to Archibald Stuart, 1786. ME 5:259

"We should try whether the prodigal might not be restrained from taking on credit the gewgaw held out to him in one hand, by seeing the keys of a prison in the other." --Thomas Jefferson to Thomas Pleasants, 1786. ME 5:325, Papers 9:472

"The maxim of buying nothing without the money in our pockets to pay for it would make of our country one of the happiest on earth." --Thomas Jefferson to Alexander Donald, 1787. ME 6:192

"Every discouragement should be thrown in the way of men who undertake to trade without capital." --Thomas Jefferson to Nathaniel Tracy, 1785. Papers 8:399

"Would a missionary appear, who would make frugality the basis of his religious system, and go through the land, preaching it up as the only road to salvation, I would join his school, though not generally disposed to seek my religion out of the dictates of my own reason and feelings of my own heart." --Thomas Jefferson to John Page, 1786. ME 5:305

"I look back to the time of the war as a time of happiness and enjoyment, when amidst the privation of many things not essential to happiness, we could not run in debt, because nobody would trust us; when we practised by necessity the maxim of buying nothing but what we had money in our pockets to pay for; a maxim which, of all others, lays the broadest foundation for happiness. I see no remedy to our evils, but an open course of law. Harsh as it may seem, it would relieve the very patients who dread it, by stopping the course of their extravagance, before it renders their affairs entirely desperate." --Thomas Jefferson to Fulwar Skipwith, 1787. ME 6:188

"It is a miserable arithmetic which makes any single privation whatever so painful as a total privation of everything which must necessarily follow the living so far beyond our income." --Thomas Jefferson to William Hay, 1787. ME 6:223

"I know of no remedy against indolence and extravagance, but a free course of justice. Everything else is merely palliative... Desperate of finding relief from a free course of justice, I look forward to the abolition of all credit, as the only other remedy which can take place." --Thomas Jefferson to Alexander Donald, 1787. ME 6:192

Banking Institutions

"That we are overdone with banking institutions which have banished the precious metals and substituted a more fluctuating and unsafe medium, that these have withdrawn capital from useful improvements and employments to nourish idleness, that the wars of the world have swollen our commerce beyond the wholesome limits of exchanging our own productions for our own wants, and that, for the emolument of a small proportion of our society who prefer these demoralizing pursuits to labors useful to the whole, the peace of the whole is endangered and all our present difficulties produced, are evils more easily to be deplored than remedied." --Thomas Jefferson to Abbe Salimankis, 1810. ME 12:379

"The system of banking [I] have... ever reprobated. I contemplate it as a blot left in all our Constitutions, which, if not covered, will end in their destruction, which is already hit by the gamblers in corruption, and is sweeping away in its progress the fortunes and morals of our citizens." --Thomas Jefferson to John Taylor, 1816. ME 15:18

"The banks... have the regulation of the safety-valves of our fortunes, and... condense and explode them at their will." --Thomas Jefferson to John Adams, 1819. ME 15:224

"The States should be urged to concede to the General Government, with a saving of chartered rights, the exclusive power of establishing banks of discount for paper." --Thomas Jefferson to John W. Eppes, 1813. ME 13:431

"I sincerely believe... that banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity under the name of funding is but swindling futurity on a large scale." --Thomas Jefferson to John Taylor, 1816. ME 15:23

A National Bank

"The incorporation of a bank and the powers assumed [by legislation doing so] have not, in my opinion, been delegated to the United States by the Constitution. They are not among the powers specially enumerated." --Thomas Jefferson: Opinion on Bank, 1791. ME 3:146

"It has always been denied by the republican party in this country, that the Constitution had given the power of incorporation to Congress. On the establishment of the Bank of the United States, this was the great ground on which that establishment was combated; and the party prevailing supported it only on the argument of its being an incident to the power given them for raising money." --Thomas Jefferson to Dr. Maese, 1809. ME 12:231

"The idea of creating a national bank I do not concur in, because it seems now decided that Congress has not that power (although I sincerely wish they had it exclusively), and because I think there is already a vast redundancy rather than a scarcity of paper medium." --Thomas Jefferson to Thomas Law, 1813. FE 9:433

"[The] Bank of the United States... is one of the most deadly hostility existing, against the principles and form of our Constitution... An institution like this, penetrating by its branches every part of the Union, acting by command and in phalanx, may, in a critical moment, upset the government. I deem no government safe which is under the vassalage of any self-constituted authorities, or any other authority than that of the nation, or its regular functionaries. What an obstruction could not this bank of the United States, with all its branch banks, be in time of war! It might dictate to us the peace we should accept, or withdraw its aids. Ought we then to give further growth to an institution so powerful, so hostile?" --Thomas Jefferson to Albert Gallatin, 1803. ME 10:437

Meeting the Banking Problem

"The monopoly of a single bank is certainly an evil. The multiplication of them was intended to cure it; but it multiplied an influence of the same character with the first, and completed the supplanting the precious metals by a paper circulation. Between such parties the less we meddle the better." --Thomas Jefferson to Albert Gallatin, 1802. ME 10:323

"In order to be able to meet a general combination of the banks against us in a critical emergency, could we not make a beginning towards an independent use of our own money, towards holding our own bank in all the deposits where it is received, and letting the treasurer give his draft or note for payment at any particular place, which, in a well-conducted government, ought to have as much credit as any private draft or bank note or bill, and would give us the same facilities which we derive from the banks?" --Thomas Jefferson to Albert Gallatin, 1803. ME 10:439

"If treasury bills are emitted on a tax appropriated for their redemption in fifteen years, and (to insure preference in the first moments of competition) bearing an interest of six per cent, there is no one who would not take them in preference to the bank paper now afloat, on a principle of patriotism as well as interest; and they would be withdrawn from circulation into private hoards to a considerable amount. Their credit once established, others might be emitted, bottomed also on a tax, but not bearing interest; and if ever their credit faltered, open public loans, on which these bills alone should be received as specie. These, operating as a sinking fund, would reduce the quantity in circulation, so as to maintain that in an equilibrium with specie. It is not easy to estimate the obstacles which, in the beginning, we should encounter in ousting the banks from their possession

of the circulation; but a steady and judicious alternation of emissions and loans would reduce them in time." --Thomas Jefferson to John W. Eppes, 1813. ME 13:275

"Bank paper must be suppressed, and the circulating medium must be restored to the nation to whom it belongs. It is the only fund on which they can rely for loans; it is the only resource which can never fail them, and it is an abundant one for every necessary purpose. Treasury bills, bottomed on taxes, bearing or not bearing interest, as may be found necessary, thrown into circulation will take the place of so much gold and silver, which last, when crowded, will find an efflux into other countries, and thus keep the quantum of medium at its salutary level. Let banks continue if they please, but let them discount for cash alone or for treasury notes." --Thomas Jefferson to John W. Eppes, 1813. ME 13:361

"Put down the banks, and if this country could not be carried through the longest war against her most powerful enemy without ever knowing the want of a dollar, without dependence on the traitorous classes of her citizens, without bearing hard on the resources of the people, or loading the public with an indefinite burden of debt, I know nothing of my countrymen. Not by any novel project, not by an charlatanerie, but by ordinary and well-experienced means; by the total prohibition of all private paper at all times, by reasonable taxes in war aided by the necessary emissions of public paper of circulating size, this bottomed on special taxes, redeemable annually as this special tax comes in, and finally within a moderate period." --Thomas Jefferson to Albert Gallatin, 1815. ME 14:356

"Our people... will give you all the necessaries of war they produce, if, instead of the bankrupt trash they now are obliged to receive for want of any other, you will give them a paper promise funded on a specific pledge, and of a size for common circulation." --Thomas Jefferson to James Monroe, 1815. ME 14:228

"Instead of funding issues of paper on the hypothecation of specific redeeming taxes (the only method of anticipating, in a time of war, the resources of times of peace, tested by the experience of nations), we are trusting to tricks of jugglers on the cards, to the illusions of banking schemes for the resources of the war, and for the cure of colic to inflations of more wind." --Thomas Jefferson to M. Correa de Serra, 1814. ME 14:224

"It is literally true that the toleration of banks of paper discount costs the United States one-half their war taxes; or, in other words, doubles the expenses of every war. Now think but for a moment, what a change of condition that would be, which should save half our war expenses, require but half the taxes, and enthral us in debt but half the time." --Thomas Jefferson to John W. Eppes, 1813. ME 13:364

"The State legislatures should be immediately urged to relinquish the right of establishing banks of discount. Most of them will comply, on patriotic principles, under the convictions of the moment; and the non-complying may be crowded into concurrence by legitimate devices." --Thomas Jefferson to Thomas Cooper, 1814. ME 14:190

The Issuance of Treasury Notes

"Necessity, as well as patriotism and confidence, will make us all eager to receive treasury notes, if founded on specific taxes. Congress may borrow of the public, and without interest, all the money they may want, to the amount of a competent circulation, by merely issuing their own promissory notes, of proper denominations for the larger purposes of circulation, but not for the small. Leave that door open for the entrance of metallic money." --Thomas Jefferson to Thomas Cooper, 1814. ME 14:189

"Treasury notes of small as well as high denomination, bottomed on a tax which would redeem them in ten years, would place at our disposal the whole circulating medium of the United States... The public... ought never more to permit its being filched from them by private speculators and disorganizers of the circulation." --Thomas Jefferson to William H. Crawford, 1815. ME 14:242

"There can be no safer deposit on earth than the Treasury of the United States." --Thomas Jefferson to Lafayette, 1825. ME 19:281

"The government of the United States have no idea of paying their debt in a depreciated medium, and... in the final liquidation of the payments which shall have been made, due regard will be had to an equitable allowance

for the circumstance of depreciation." --Thomas Jefferson to Jean Baptiste de Ternant, 1791. ME 8:247

Commercial Banking

"The art and mystery of banks... is established on the principle that '*private* debts are a public blessing.' That the evidences of those private debts, called bank notes, become active capital, and aliment the whole commerce, manufactures, and agriculture of the United States. Here are a set of people, for instance, who have bestowed on us the great blessing of running in our debt about two hundred millions of dollars, without our knowing who they are, where they are, or what property they have to pay this debt when called on; nay, who have made us so sensible of the blessings of letting them run in our debt, that we have exempted them by law from the repayment of these debts beyond a give proportion (generally estimated at one-third). And to fill up the measure of blessing, instead of paying, they receive an interest on what they owe from those to whom they owe; for all the notes, or evidences of what they owe, which we see in circulation, have been lent to somebody on an interest which is levied again on us through the medium of commerce. And they are so ready still to deal out their liberalities to us, that they are now willing to let themselves run in our debt ninety millions more, on our paying them the same premium of six or eight per cent interest, and on the same legal exemption from the repayment of more than thirty millions of the debt, when it shall be called for." --Thomas Jefferson to John W. Eppes, 1813. ME 13:420

"The bank mania... is raising up a moneyed aristocracy in our country which has already set the government at defiance, and although forced at length to yield a little on this first essay of their strength, their principles are unyielded and unyielding. These have taken deep root in the hearts of that class from which our legislators are drawn, and the sop to Cerberus from fable has become history. Their principles lay hold of the good, their pelf of the bad, and thus those whom the Constitution had placed as guards to its portals, are sophisticated or suborned from their duties." --Thomas Jefferson to Josephus B. Stuart, 1817. ME 15:112

"Put down all banks, admit none but a *metallic circulation* that will take its proper level with the like circulation in other countries, and then our manufacturers may work in fair competition with those of other countries, and the import duties which the government may lay for the purposes of revenue will so far place them above equal competition." --Thomas Jefferson to Charles Pinckney, 1820. ME 15:280

"But it will be asked, are we to have no banks? Are merchants and others to be deprived of the resource of short accommodations, found so convenient? I answer, let us have banks; but let them be such as are alone to be found in any country on earth, except Great Britain. There is not a bank of discount on the continent of Europe (at least there was not one when I was there) which offers anything but cash in exchange for discounted bills." --Thomas Jefferson to John W. Eppes, 1813. ME 13:277

"No one has a natural right to the trade of a money lender, but he who has the money to lend. Let those then among us who have a moneyed capital and who prefer employing it in loans rather than otherwise, set up banks and give cash or national bills for the notes they discount. Perhaps, to encourage them, a larger interest than is legal in the other cases might be allowed them, on the condition of their lending for short periods only." --Thomas Jefferson to John W. Eppes, 1813. ME 13:277

"If the debt which the banking companies owe be a blessing to anybody, it is to themselves alone, who are realizing a solid interest of eight or ten per cent on it. As to the public, these companies have banished all our gold and silver medium, which, before their institution, we had without interest, which never could have perished in our hands, and would have been our salvation now in the hour of war; instead of which they have given us two hundred million of froth and bubble, on which we are to pay them heavy interest, until it shall vanish into air... We are warranted, then, in affirming that this parody on the principle of 'a public debt being a public blessing,' and its mutation into the blessing of private instead of public debts, is as ridiculous as the original principle itself. In both cases, the truth is, that capital may be produced by industry, and accumulated by economy; but jugglers only will propose to create it by legerdemain tricks with paper." --Thomas Jefferson to John W. Eppes, 1813. ME 13:423

"Everything predicted by the enemies of banks, in the beginning, is now coming to pass. We are to be ruined now by the deluge of bank paper. It is cruel that such revolutions in private fortunes should be at the mercy of avaricious adventurers, who, instead of employing their capital, if any they have, in manufactures, commerce, and other useful pursuits, make it an instrument to burden all the interchanges of property with their swindling

profits, profits which are the price of no useful industry of theirs." --Thomas Jefferson to Thomas Cooper, 1814. ME 14:61

"Certainly no nation ever before abandoned to the avarice and jugglings of private individuals to regulate according to their own interests, the quantum of circulating medium for the nation -- to inflate, by deluges of paper, the nominal prices of property, and then to buy up that property at 1s. in the pound, having first withdrawn the floating medium which might endanger a competition in purchase. Yet this is what has been done, and will be done, unless stayed by the protecting hand of the legislature. The evil has been produced by the error of their sanction of this ruinous machinery of banks; and justice, wisdom, duty, all require that they should interpose and arrest it before the schemes of plunder and spoilation desolate the country." --Thomas Jefferson to William C. Rives, 1819. ME 15:232

"It is said that our paper is as good as silver, because we may have silver for it at the bank where it issues. This is not true. One, two, or three persons might have it; but a general application would soon exhaust their vaults, and leave a ruinous proportion of their paper in its intrinsic worthless form." --Thomas Jefferson to John W. Eppes, 1813. ME 13:426

"To the existence of banks of *discount* for *cash*... there can be no objection, because there can be no danger of abuse, and they are a convenience both to merchants and individuals. I think they should even be encouraged, by allowing them a larger than legal interest on short discounts, and tapering thence, in proportion as the term of discount is lengthened, down to legal interest on those of a year or more. Even banks of *deposit*, where cash should be lodged, and a paper acknowledgment taken out as its representative, entitled to a return of the cash on demand, would be convenient for remittances, travelling persons, etc. But, liable as its cash would be to be pilfered and robbed, and its paper to be fraudulently re-issued, or issued without deposit, it would require skilful and strict regulation." --Thomas Jefferson to John W. Eppes, 1813. ME 13:431

"I am an enemy to all banks discounting bills or notes for anything but coin." --Thomas Jefferson to Thomas Cooper, 1814. ME 14:61

Regulating Banking Institutions

"The principle of rotation... in the body of [bank] directors... breaks in upon the *espirit de corps* so apt to prevail in permanent bodies; it gives a chance for the public eye penetrating into the sanctuary of those proceedings and practices, which the avarice of the directors may introduce for their personal emolument, and which the resentments of excluded directors, or the honesty of those duly admitted, might betray to the public; and it gives an opportunity at the end of the year, or at other periods, of correcting a choice, which on trial, proves to have been unfortunate." --Thomas Jefferson to Albert Gallatin, 1803. ME 10:437

ME, FE = Memorial Edition, Ford Edition. See Sources.

Cross References

To other sections in *Thomas Jefferson on Politics & Government*:-

Commerce & Agriculture | Interpreting the Constitution

The National Debt

Thomas Jefferson on Politics & Government

38. The National Debt

Loading up the nation with debt and leaving it for the following generations to pay is morally irresponsible. Excessive debt is a means by which governments oppress the people and waste their substance. No nation has a right to contract debt for periods longer than the majority contracting it can expect to live.

"I sincerely believe... that the principle of spending money to be paid by posterity under the name of funding is but swindling futurity on a large scale." --Thomas Jefferson to John Taylor, 1816. ME 15:23

"[With the decline of society] begins, indeed, the *bellum omnium in omnia* [war of all against all], which some philosophers observing to be so general in this world, have mistaken it for the natural, instead of the abusive state of man. And the fore horse of this frightful team is public debt. Taxation follows that, and in its train wretchedness and oppression." --Thomas Jefferson to Samuel Kercheval, 1816. ME 15:40

The Nation's Credit

"Though much an enemy to the system of borrowing, yet I feel strongly the necessity of preserving the power to borrow. Without this, we might be overwhelmed by another nation, merely by the force of its credit." --Thomas Jefferson to the Commissioners of the Treasury, 1788. ME 6:423

"I am anxious about everything which may affect our credit. My wish would be, to possess it in the highest degree, but to use it little. Were we without credit, we might be crushed by a nation of much inferior resources, but possessing higher credit." --Thomas Jefferson to George Washington, 1788. ME 6:453

"Though I am an enemy to the using our credit but under absolute necessity, yet the possessing a good credit I consider as indispensable in the present system of carrying on war. The existence of a nation having no credit is always precarious." --Thomas Jefferson to James Madison, 1788. ME 6:455

"I wish it were possible to obtain a single amendment to our Constitution. I would be willing to depend on that alone for the reduction of the administration of our government; I mean an additional article taking from the Federal Government the power of borrowing. I now deny their power of making paper money or anything else a legal tender. I know that to pay all proper expenses within the year would, in case of war, be hard on us. But not so hard as ten wars instead of one. For wars could be reduced in that proportion; besides that the State governments would be free to lend *their credit* in borrowing quotas." --Thomas Jefferson to John Taylor, 1798. ME 10:64

The Limits on Contracting Debt

"The term of redemption must be moderate, and at any rate within the limits of [the government's] rightful powers. But what limits, it will be asked, does this prescribe to their powers? What is to hinder them from creating a perpetual debt? The laws of nature, I answer. The earth belongs to the living, not to the dead. The will and the power of man expire with his life, by nature's law." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:169

"We acknowledge that our children are born free; that that freedom is the gift of nature, and not of him who

begot them; that though under our care during infancy, and therefore of necessity under a duly tempered authority, that care is confided to us to be exercised for the preservation and good of the child only; and his labors during youth are given as a retribution for the charges of infancy. As he was never the property of his father, so when adult he is *sui juris*, entitled himself to the use of his own limbs and the fruits of his own exertions: so far we are advanced, without mind enough, it seems, to take the whole step." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:357

"Then I say, the earth belongs to each of these generations during its course, fully and in its own right. The second generation receives it clear of the debts and incumbrances of the first, the third of the second, and so on. For if the first could charge it with a debt, then the earth would belong to the dead and not to the living generation. Then, no generation can contract debts greater than may be paid during the course of its own existence." --Thomas Jefferson to James Madison, 1789. ME 7:455, Papers 15:393

"[Using], for instance, the table of M. de Buffon, [it can be determined that] the half of those of 21 years and upwards living at any one instant of time will be dead in 18 years, 8 months, or say 19 years as the nearest integral number. Then 19 years is the term beyond which neither the representatives of a nation nor even the whole nation itself assembled can validly extend a debt... With respect to future debts, would it not be wise and just for [a] nation to declare in [its] constitution that neither the legislature nor the nation itself can validly contract more debt than they may pay within their own age, or within the term of 19 years? And that all future contracts shall be deemed void as to what shall remain unpaid at the end of 19 years from their date?" --Thomas Jefferson to James Madison, 1789. Papers 15:394

"The conclusion then, is, that neither the representatives of a nation, nor the whole nation itself assembled, can validly engage debts beyond what they may pay in their own time." --Thomas Jefferson to James Madison, 1789. ME 7:457, Papers 15:398n

"I suppose that the received opinion, that the public debts of one generation devolve on the next, has been suggested by our seeing, habitually, in private life, that he who succeeds to lands is required to pay the debts of his predecessor; without considering that this requisition is municipal only, not moral, flowing from the will of the society, which has found it convenient to appropriate the lands of a decedent on the condition of a payment of his debts; but that between society and society, or generation and generation, there is no municipal obligation, no umpire but the law of nature." --Thomas Jefferson to James Madison, 1789. ME 7:458, Papers 15:395

"Funding I consider as limited, rightfully, to a redemption of the debt within the lives of a majority of the generation contracting it; every generation coming equally, by the laws of the Creator of the world, to the free possession of the earth He made for their subsistence, unincumbered by their predecessors, who, like them, were but tenants for life." --Thomas Jefferson to John Taylor, 1816. ME 15:18

"[The natural right to be free of the debts of a previous generation is] a salutary curb on the spirit of war and indebtment, which, since the modern theory of the perpetuation of debt, has drenched the earth with blood, and crushed its inhabitants under burdens ever accumulating." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:272

Saddling Posterity with Debt

"We believe--or we act as if we believed--that although an individual father cannot alienate the labor of his son, the aggregate body of fathers may alienate the labor of all their sons, of their posterity, in the aggregate, and oblige them to pay for all the enterprises, just or unjust, profitable or ruinous, into which our vices, our passions or our personal interests may lead us. But I trust that this proposition needs only to be looked at by an American to be seen in its true point of view, and that we shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves; and consequently within what may be deemed the period of a generation, or the life of the majority." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:357

"It is incumbent on every generation to pay its own debts as it goes. A principle which if acted on would save one-half the wars of the world." --Thomas Jefferson to A. L. C. Destutt de Tracy, 1820. FE 10:175

"Ought not then the right of each successive generation to be guaranteed against the dissipations and corruptions

of those preceding, by a fundamental provision in our Constitution? And if that has not been made, does it exist the less, there being between generation and generation as between nation and nation no other law than that of nature? And is it the less dishonest to do what is wrong because not expressly prohibited by written law? Let us hope our moral principles are not yet in that stage of degeneracy, and that in instituting the system of finance to be hereafter pursued we shall adopt the only safe, the only lawful and honest one, of borrowing on such short terms of reimbursement of interest and principal as will fall within the accomplishment of our own lives." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:360

A Tax for Every Debt

"It is a wise rule and should be fundamental in a government disposed to cherish its credit and at the same time to restrain the use of it within the limits of its faculties, "never to borrow a dollar without laying a tax in the same instant for paying the interest annually and the principal within a given term; and to consider that tax as pledged to the creditors on the public faith." On such a pledge as this, sacredly observed, a government may always command, on a *reasonable interest,* all the lendable money of their citizens, while the necessity of an equivalent tax is a salutary warning to them and their constituents against oppressions, bankruptcy, and its inevitable consequence, revolution." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:269

"Our government has not as yet begun to act on the rule of loans and taxation going hand in hand. Had any loan taken place in my time, I should have strongly urged a redeeming tax." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:273

"Of the modes which are within the limits of right, that of raising within the year its whole expenses by taxation, might be beyond the abilities of our citizens to bear. It is, moreover, generally desirable that the public contributions should be as uniform as practicable from year to year, that our habits of industry and of expense may become adapted to them; and that they may be duly digested and incorporated with our annual economy." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:359

"We should now set the example of appropriating some particular tax [for loans made] sufficient to pay the interest annually and the principal within a fixed term, less than nineteen years." --Thomas Jefferson to John Wayles Eppes, 1813. ME 13:273

"Interest, simple or compound, is a compensation for the use of money." --Thomas Jefferson to John Nelson, 1818. ME 18:300

Maintaining Good Credit

"I told... President [Washington] all that was ever necessary to establish our credit was an efficient government and an honest one, declaring it would sacredly pay our debts, laying taxes for this purpose and applying them to it." --Thomas Jefferson: The Anas, 1792. ME 1:319

"The English credit is the first, because they never open a loan without laying and appropriating taxes for the payment of the interest, and there has never been an instance of their failing one day in that payment." --Thomas Jefferson to George Washington, 1788. ME 6:452

"Equal provision for the interest, adding to it a certain prospect for the principal, will give us a preference to all nations, the English not excepted." --Thomas Jefferson to James Madison, 1788. ME 6:456

"I deem [this one of] the essential principles of our government and consequently [one] which ought to shape its administration:... The honest payment of our debts and sacred preservation of the public faith. " --Thomas Jefferson: 1st Inaugural, 1801. ME 3:322

"There can never be a fear but that the paper which represents the public debt will be ever sacredly good. The public faith is bound for this, and no change of system will ever be permitted to touch this; but no other paper stands on ground equally sure." --Thomas Jefferson to William Short, 1792. ME 8:317

"It is not our desire to pay off... bills [of exchange in paper money] according to the present depreciation, but according to their actual value in hard money at the time they were drawn, with interest. The State having received value, so far as it is just it should be substantially paid. All beyond this would be plunder, made by some person or other." --Thomas Jefferson to the Virginia Delegates in Congress, 1781. ME 4:390, Papers 5:152

"I once thought that in the event of a war we should be obliged to suspend paying the interest of the public debt. But a dozen years more of experience and observation on our people and government have satisfied me it will never be done. The sense of the necessity of public credit is so universal and so deeply rooted that no other necessity will prevail against it." --Thomas Jefferson to William Short, 1814. ME 14:217

Freeing the Nation from Debt

"I consider the fortunes of our republic as depending in an eminent degree on the extinguishment of the public debt before we engage in any war; because that done, we shall have revenue enough to improve our country in peace and defend it in war without recurring either to new taxes or loans. But if the debt should once more be swelled to a formidable size, its entire discharge will be despaired of, and we shall be committed to the English career of debt, corruption and rottenness, closing with revolution. The discharge of public debt, therefore, is vital to the destinies of our government." --Thomas Jefferson to Albert Gallatin, 1809. FE 9:264

"There [is a measure] which if not taken we are undone...[It is] to cease borrowing money and to pay off the national debt. If this cannot be done without dismissing the army and putting the ships out of commission, haul them up high and dry and reduce the army to the lowest point at which it was ever established. There does not exist an engine so corruptive of the government and so demoralizing of the nation as a public debt. It will bring on us more ruin at home than all the enemies from abroad against whom this army and navy are to protect us." --Thomas Jefferson to Nathaniel Macon, 1821. (*) FE 10:193

"To preserve [the] independence [of the people,] we must not let our rulers load us with perpetual debt. We must make our election between *economy and liberty*, or *profusion and servitude.* If we run into such debts as that we must be taxed in our meat and in our drink, in our necessaries and our comforts, in our labors and our amusements, for our callings and our creeds, as the people of England are, our people, like them, must come to labor sixteen hours in the twenty-four, give the earnings of fifteen of these to the government for their debts and daily expenses, and the sixteenth being insufficient to afford us bread, we must live, as they now do, on oatmeal and potatoes, have no time to think, no means of calling the mismanagers to account, but be glad to obtain subsistence by hiring ourselves to rivet their chains on the necks of our fellow-sufferers." --Thomas Jefferson to Samuel Kercheval, 1816. ME 15:39

"No earthly consideration could induce my consent to contract such a debt as England has by her wars for commerce, to reduce our citizens by taxes to such wretchedness, as that laboring sixteen of the twenty-four hours, they are still unable to afford themselves bread, or barely to earn as much oatmeal or potatoes as will keep soul and body together. And all this to feed the avidity of a few millionary merchants and to keep up one thousand ships of war for the protection of their commercial speculations." --Thomas Jefferson to William H. Crawford, 1816. ME 15:29

"Our distance from the wars of Europe, and our disposition to take no part in them, will, we hope, enable us to keep clear of the debts which they occasion to other powers." --Thomas Jefferson to C. W. F. Dumas, 1790. ME 8:47

ME, FE = Memorial Edition, Ford Edition. See Sources.

Cross References

To other sections in *Thomas Jefferson on Politics & Government*:-

Money & Banking | Taxation & Fiscal Responsibility

Top | Previous Section | Next Section | Table of Contents | Front Page

Clyatt v. United States, 197 U.S. 207, 25 S.Ct. 429 (1905)

Supreme Court of the United States.

SAMUEL M. CLYATT

v.

UNITED STATES.

No. 235.

Argued December 13, 14, 1904.

Decided March 13, 1905.

ON WRIT of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit, bringing up for review a judgment of the Circuit Court for the Northern District of Florida, convicting defendant of returning certain specified persons to a condition of peonage, which judgment had been taken to the Circuit Court of Appeals by a writ of error to the Circuit Court. *Reversed* and the cause remanded for a new trial.

Statement by Mr. Justice **Brewer:**

Sections 1990 and 5526, Rev. Stat. (U. S. Comp. Stat. 1901, pp. 1266, 3715), read:

> 'Sec. 1990. The holding of any person to service or labor under the system known as peonage is abolished and forever prohibited in the territory of New Mexico, or in any other territory or state of the United States; and all acts, laws, resolutions, orders, regulations, or usages of the territory of New Mexico, or of any other territory or state, which have heretofore established, maintained, or enforced, or by virtue of which any attempt shall hereafter be made to establish, maintain, or enforce, directly or indirectly, the voluntary or involuntary service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise, are declared null and void.'

> 'Sec. 5526. Every person who holds, arrests, returns, or causes to be held, arrested, or returned, or in any manner aids in the arrest or return of any person to a condition of peonage, shall be punished by a fine of not less than one thousand nor more than five thousand dollars, or by imprisonment not less than one year nor more than five years, or by both.'

On November 21, 1901, the grand jury returned into the circuit court of the United States for the northern district of Florida an indictment in two counts, the first of which is as follows:

'The grand jurors of the United States of America impaneled and sworn within and for the district aforesaid, on their oaths present, that one Samuel M. Clyatt, heretofore, to wit: on the eleventh day of February, in the year of our Lord one thousand nine hundred and one, in the county of Levy, state of Florida, within the

district aforesaid, and within the jurisdiction of this court, did then and there unlawfully and knowingly return one Will Gordon and one Mose Ridley to a condition of peonage, by forcibly and against the will of them, the said Will Gordon and the said Mose Ridley, returning them, the said Will Gordon and Mose Ridley, to work to and for Samuel M. Clyatt, D. T. Clyatt, and H. H. Tift, copartners doing business under the firm name and style of Clyatt & Tift, to be held by them, the said Clyatt & Tift, to work out a debt claimed to be due to them, the said Clyatt & Tift, by the said Will Gordon and Mose Ridley; contrary to the form of the statute in such case made and provided, and against the peace and dignity of the United States.'

The second count differs only in charging that defendant caused and aided in returning Gordon and Ridley. A trial resulted in a verdict of guilty, and thereupon the defendant was sentenced to confinement at hard labor for four years. The case was taken on appropriate writ to the court of appeals for the fifth circuit, which certified to this court three questions. Subsequently the entire record was brought here on a writ of certiorari, and the case was heard on its merits.

Mr. Justice **Brewer** delivered the opinion of the court:

The constitutionality and scope of §§ 1990 and 5526 present the first questions for our consideration. They prohibit peonage. What is peonage? It may be defined as a status or condition of compulsory service, based upon the indebtedness of the peon to the master. The basal fact is indebtedness. As said by Judge Benedict, delivering the opinion in *Jaremillo* v. *Romero*, 1 N. M. 190, 194: 'One fact existed universally: all were indebted to their masters. This was the cord by which they seemed bound to their master's service.' Upon this is based a condition of compulsory service. Peonage is sometimes classified as voluntary or involuntary; but this implies simply a difference in the mode of origin, but none in the character of the servitude. The one exists where the debtor voluntarily contracts to enter the service of his creditor. The other is forced upon the debtor by some provision of law. But peonage, however created, is compulsory service,--involuntary servitude. The peon can release himself therefrom, it is true, by the payment of the debt, but otherwise the service is enforced. A clear distinction exists between peonage and the voluntary performance of labor or rendering of services in payment of a debt. In the latter case the debtor, though contracting to pay his indebtedness by labor or service, and subject, like any other contractor, to an action for damages for breach of that contract, can elect at any time to break it, and no law or force compels performance or a continuance of the service. We need not stop to consider any possible limits or exceptional cases, such as the service of a sailor (*Robertson* v. *Baldwin*, 165 U. S. 275, 41 L. ed. 715, 17 Sup. Ct. Rep. 326), or the obligations of a child to its parents, or of an apprentice to his master, or the power of the legislature to make unlawful, and punish criminally, an abandonment by an employee of his post of labor in any extreme cases. That which is contemplated by the statute is compulsory service to secure the payment of a debt. Is this legislation within the power of Congress? It may be conceded, as a general proposition, that the ordinary relations of individual to individual are subject to the control of the states, and are not intrusted to the general government; but the 13th Amendment, adopted as an outcome of the Civil War, reads:

> 'Sec. 1. Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.
>
> 'Sec. 2. Congress shall have power to enforce this article by appropriate legislation.'

This amendment denounces a status or condition, irrespective of the manner or authority by which it is created. The prohibitions of the 14th and 15th Amendments are largely upon the acts of the states; but the

13th Amendment names no party or authority, but simply forbids slavery and involuntary servitude, grants to Congress power to enforce this prohibition by appropriate legislation. The differences between the 13th and subsequent amendments have been so fully considered by this court that it is enough to refer to the decisions. In the *Civil Rights Cases*, 109 U. S. 3, 20, 23, 27 L. ed. 835, 842, 843, 3 Sup. Ct. Rep. 18, 28, 30, Mr. Justice Bradley, delivering the opinion of the court, uses this language:

> 'This amendment, as well as the 14th, is undoubtedly self-executing without any ancillary legislation, so far as its terms are applicable to any existing state of circumstances. By its own unaided force and effect it abolished slavery, and established universal freedom. Still, legislation may be necessary and proper to meet all the various cases and circumstances to be affected by it, and to prescribe proper modes of redress for its violation in letter or spirit. And such legislation may be primary and direct in its character; for the amendment is not a mere prohibition of state laws establishing or upholding slavery, but an absolute declaration that slavery or involuntary servitude shall not exist in any part of the United States. . . .
>
> 'We must not forget that the province and scope of the 13th and 14th Amendments are different; the former simply abolished slavery: the latter prohibited the states from abridging the privileges or immunities of citizens of the United States; from depriving them of life, liberty, or property without due process of law, and from denying to any the equal protection of the laws. The amendments are different, and the powers of Congress under them are different. What Congress has power to do under one, it may not have power to do under the other. Under the 13th Amendment, it has only to do with slavery and its incidents. Under the 14th Amendment, it has power to counteract and render nugatory all state laws and proceedings which have the effect to abridge any of the privileges or immunities of citizens of the United States, or to deprive them of life, liberty, or property without due process of law, or to deny to any of them the equal protection of the laws. Under the 13th Amendment, the legislation, so far as necessary or proper to eradicate all forms and incidents of slavery and involuntary servitude, may be direct and primary, operating upon the acts of individuals, whether sanctioned by state legislation or not; under the 14th, as we have already shown, it must necessarily be, and can only be, corrective in its character, addressed to counteract and afford relief against state regulations or proceedings.'

In *Plessy* v. *Ferguson*, 163 U. S. 537, 542, 41 L. ed. 256, 257, 16 Sup. Ct. Rep. 1138, 1140, Mr. Justice Brown, delivering the opinion of the court, said:

> 'That it does not conflict with the 13th Amendment, which abolished slavery and involuntary servitude except as a punishment for crime, is too clear for argument. Slavery implies involuntary servitude,--a state of bondage; the ownership of mankind as a chattel, or at least the control of the labor and services of one man for the benefit of another, and the absence of a legal right to the disposal of his own person, property, and services. This amendment was said in the *Slaughter House Cases*, 16 Wall. 36, 21 L. ed. 394, to have been intended primarily to abolish slavery, as it had been previously known in this country, and that it equally forbade Mexican peonage or the Chinese coolie trade, when they amounted to slavery or involuntary servitude, and that the use of the word 'servitude' was intended to prohibit the use of all forms of involuntary slavery, of whatever class or name.'

Other authorities to the same effect might be cited. It is not open to doubt that Congress may enforce the 13th

Amendment by direct legislation, punishing the holding of a person in slavery or in involuntary servitude except as a punishment for crime. In the exercise of that power Congress has enacted these sections denouncing peonage, and punishing one who holds another in that condition of involuntary servitude. This legislation is not limited to the territories or other parts of the strictly national domain, but is operative in the states and wherever the sovereignty of the United States extends. We entertain no doubt of the validity of this legislation, or its applicability to the case of any person holding and wherever the sovereignty of the United whether there be a municipal ordinance or state law sanctioning such holding. It operates directly on every citizen of the Republic, wherever his residence may be.

Section 5526 punishes 'every person who holds, arrests, returns, or causes to be held, arrested, or returned.' Three distinct acts are here mentioned,-- holding, arresting, returning. The disjunctive 'or' indicates the separation between them, and shows that either one may be the subject of indictment and punishment. A party may hold another in a state of peonage without ever having arrested him for that purpose. He may come by inheritance into the possession of an estate in which the peon is held, and he simply continues the condition which was existing before he came into possession. He may also arrest an individual for the purpose of placing him in a condition of peonage, and this whether he be the one to whom the involuntary service is to be rendered or simply employed for the purpose of making the arrest. Or he may, after one has fled from a state of peonage, return him to it, and this whether he himself claims the service or is acting simply as an agent of another to enforce the return.

The indictment charges that the defendant did 'unlawfully and knowingly return one Will Gordon and one Mose Ridley to a condition of peonage, by forcibly, and against the will of them, the said Will Gordon and the said Mose Ridley, returning them, the said Will Gordon and the said Mose Ridley, to work to and for Samuel M. Clyatt.'

Now a 'return' implies the prior existence of some state or condition. Webster defines it 'to turn back; to go or come again to the same place or condition.' In the Standard dictionary it is defined 'to cause to take again a former position; put, carry, or send back, as to a former place or holder.' A technical meaning in the law is thus given in Black's Law Dictionary: 'The act of a sheriff, constable, or other ministerial officer, in delivering back to the court a writ, notice, or other paper.'

It was essential, therefore, under the charge in this case, to show that Gordon and Ridley had been in a condition of peonage, to which, by the act of the defendant, they were returned. We are not at liberty to transform this indictment into one charging that the defendant held them in a condition or state of peonage, or that he arrested them with a view of placing them in such condition or state. The pleader has seen fit to charge a return to a condition of peonage. The defendant had a right to rely upon that as the charge, and to either offer testimony to show that Gordon and Ridley had never been in a condition of peonage, or to rest upon the government's omission of proof of that fact.

We must, therefore, examine the testimony; and the first question that arises is whether the record sufficiently shows that it contains all the testimony. The bill of exceptions, after reciting the impaneling of the jury, proceeds in these words:

'And thereupon the plaintiff, to maintain the issues upon its part, produced and offered as a witness, James R. Dean, who, being first duly sworn, did testify as follows.'

That recital is followed by what purports to be the testimony of the witness. Then follows in succession the

testimony of several witnesses, each being preceded by a statement in a form similar to this: 'The plaintiff then introduced and offered as a witness, H. S. Sutton, who, being first duly sworn, did testify as follows.' At the close of the testimony of the last witness named is this statement:

'Whereupon the plaintiff rests its case.

'Defendant rests--introduces no testimony.

'And the said judge, after charging the jury on the law in the case, submitted the said issues and the evidence so given on the trial, to the jury, and the jury aforesaid then and there gave their verdict for the plaintiff.'

It is true there is no affirmative statement in the bill of exceptions that it contains all the testimony, but such omission is not fatal. This question was presented in *Gunnison County* v. *E. H. Rollins & Sons*, 173 U. S. 255, 43 L. ed. 689, 19 Sup. Ct. Rep. 390, a civil case, brought to this court on certiorari to the circuit court of appeals, which court had held that the bill of exceptions did not purport to contain all the evidence adduced at the trial, and for that reason did not consider the question whether error was committed in instructing the jury to find for the defendant. Mr. Justice Harlan, delivering the unanimous opinion of the court, disposed of that question in these words (p. 261, L. ed. p. 693, Sup. Ct. Rep. p. 392):

> 'We are of opinion that the bill of exceptions should be taken as containing all the evidence. It appears that as soon as the jury was sworn to try the issues in the cause 'the complainants, to sustain the issues on their part, offered the following oral and documentary evidence.' Then follow many pages of testimony on the part of the plaintiffs, when this entry appears: 'Whereupon complainants rested.' Immediately after comes this entry: 'Thereupon the defendants, to sustain the issues herein joined on their part, produced the following evidence.' Then follow many pages of evidence given on behalf of the defendant, and the evidence of a witness recalled by the defendant, concluding with this entry: 'Whereupon the further proceedings herein were continued until the 20th day of May, 1896, at 10 o'clock A. M.' Immediately following this entry: 'Wednesday, May 20th, at 10 o'clock, the further trial of this cause was continued as follows.' The transcript next shows some discussion by counsel as to the exclusion of particular evidence, after which is this entry: 'Thereupon counsel for defendant made a formal motion under the evidence on both sides that the court instruct the jury to return a verdict for the defendant.' Although the bill of exceptions does not state, in words, that it contains all the evidence, the above entries sufficiently show that it does contain all the evidence.'

The present case is completely covered by that decision. If, in a civil case, such recitals in the bill of exceptions are sufficient to show that it contains all the testimony, *a fortiori* should this be the rule in a criminal the question of his guilt by an omission from not be deprived of a full consideration of the question of his guilty by an omission from the bill of the technical recital that it contains all the evidence.

While no motion or request was made that the jury be instructed to find for defendant, and although such a motion is the proper method of presenting the question whether there is evidence to sustain the verdict, yet *Wiborg* v. *United States*, 163 U. S. 632, 658, 41 L. ed. 290, 298, 16 Sup. Ct. Rep. 1127, 1197, justifies us in examining the question in case a plain error has been committed in a matter so vital to the defendant.

The testimony discloses that the defendant, with another party, went to Florida, and caused the arrest of Gordon and Ridley on warrants issued by a magistrate in Georgia for larceny; but there can be little doubt that these criminal proceedings were only an excuse for securing the custody of Gordon and Ridley, and taking them back to Georgia to work out a debt. At any rate, there was abundant testimony from which the jury could find that to have been the fact. While this is true, there is not a scintilla of testimony to show that Gordon and Ridley were ever theretofore in a condition of peonage. That they were in debt, and that they had left Georgia and gone to Florida without paying that debt, does not show that they had been held in a condition of peonage, or were ever at work, willingly or unwillingly, for their creditor. We have examined the testimony with great care to see if there was anything which would justify a finding of the fact, and can find nothing. No matter how severe may be the condemnation which is due to the conduct of a party charged with a criminal offense, it is the imperative duty of a court to see that all the elements of his crime are proved, or at least that testimony is offered which justifies a jury in finding those elements. Only in the exact administration of the law will justice in the long run be done, and the confidence of the public in such administration be maintained.

We are constrained, therefore, to order a reversal of the judgment, and remand the case for a new trial.

Mr. Justice **McKenna** concurs in the judgment.

Mr. Justice **Harlan:**

I concur with my brethren in holding that the statutes in question relating to peonage are valid under the Constitution of the United States. I agree, also, that the record sufficiently shows that it contains all the evidence introduced at the trial.

But I cannot agree in holding that the trial court erred in not taking the case from the jury. Without going into the details of the evidence, I care only to say that, in my opinion, there was evidence tending to make a case within the statute. The opinion of the court concedes that there was abundant testimony to show that the accused, with another, went from Georgia to Florida to arrest the two negroes, Gordon and Ridley, and take them, against their will, back to Georgia to work out a debt. And they were taken to Georgia by force. It is conceded that peonage is based upon the indebtedness of the peon to the master. The accused admitted to one of the witnesses that the negroes owed him. In any view, there was no motion or request to direct a verdict for the defendant. The accused made no objection to the submission of the case to the jury, and it is going very far to hold in a case like this, disclosing barbarities of the worst kind against these negroes, that he trial court erred in sending the case to the jury.

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42 U.S.C.A. § 1994 **UNITED STATES CODE ANNOTATED**

TITLE 42. THE PUBLIC HEALTH AND WELFARE

CHAPTER 21--CIVIL RIGHTS

SUBCHAPTER I--GENERALLY

Current through P.L. 107-11, approved 5-28-01

§ 1994. Peonage abolished

The holding of any person to service or labor under the system known as peonage is abolished and forever prohibited in any Territory or State of the United States; and all acts, laws, resolutions, orders, regulations, or usages of any Territory or State, which have heretofore established, maintained, or enforced, or by virtue of which any attempt shall hereafter be made to establish, maintain, or enforce, directly or indirectly, the voluntary or involuntary service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise, are declared null and void.

CREDIT(S)

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(R.S. § 1990.)

<General Materials (GM) - References, Annotations, or Tables>

§ 1564. Repealed. Pub. L. 101–508, title XI, § 11801(a)(38), Nov. 5, 1990, 104 Stat. 1388–521]

Section, added Pub. L. 91–172, title IV, § 401(b)(1), Dec. 30, 1969, 83 Stat. 600; amended Pub. L. 94–455, title XIX, §§ 1901(b)(1)(J)(vi), (21)(A)(ii), 1906 (b)(13)(A), Oct. 4, 1976, 90 Stat. 1791, 1797, 1834, related to transitional rules in the case of certain controlled corporations.

Sec. 1581. - Peonage; obstructing enforcement

(a)

Whoever holds or returns any person to a condition of peonage, or arrests any person with the intent of placing him in or returning him to a condition of peonage, shall be fined under this title or imprisoned not more than 20 years, or both. If death results from the violation of this section, or if the violation includes kidnapping or an attempt to kidnap, aggravated sexual abuse or the attempt to commit aggravated sexual abuse, or an attempt to kill, the defendant shall be fined under this title or imprisoned for any term of years or life, or both.

(b)

Whoever obstructs, or attempts to obstruct, or in any way interferes with or prevents the enforcement of this section, shall be liable to the penalties prescribed in subsection (a)

Bailey v. Alabama, 219 U.S. 219, 31 S.Ct. 145 (1911)

ALONZO BAILEY, Plff. in Err.,

v.

STATE OF ALABAMA.

No. 300.

Supreme Court of the United States.

Decided January 3, 1911.

Mr. Justice Hughes delivered the opinion of the court:

This is a writ of error to review a judgment of the supreme court of the state of Alabama, affirming a judgment of conviction in the Montgomery city court. The statute upon which the conviction was based is assailed as in violation of the 14th Amendment of the Constitution of the United States upon the ground that it deprived the plaintiff in error of his liberty without due process of law and denied him the equal protection of the laws, and also of the 13th Amendment, and of the act of Congress providing for the enforcement of that Amendment, in that the effect of the statute is to enforce involuntary servitude by compelling personal service in liquidation of a debt.

The statute in question is § 4730 of the Code of Alabama of 1896, as amended in 1903 and 1907. The section of the Code as it stood before the amendments provided that any person who, with intent to injure or defraud his employer, entered into a written contract for service, and thereby obtained from his employer money or other personal property, and with like intent and without just cause, and without refunding the money or paying for the property, refused to perform the service, should be punished as if he had stolen it. In 1903 (Gen. Acts [Ala.] 1903, p. 345) the section was amended so as to make the refusal or failure to perform the service, or to refund the money, or pay for the property, without just cause, prima facie evidence of the intent to injure or defraud. This amendment was enlarged by that of 1907. Gen. Acts. (Ala.) 1907, p. 636. The section, thus amended, reads as follows:

> 'Any person who, with intent to injure or defraud his employer, enters into a contract in writing for the performance of any act of service, and thereby obtains money or other personal property from such employer, and with like intent, and without just cause, and without refunding such money, or paying for such property, refuses or fails to perform such act or service, must on conviction be punished by a fine in double the damage suffered by the injured party, but not more than $300, one half of said fine to go to the county and one half to the party injured; and any person who, with intent to injure or defraud his landlord, enters into any contract in writing for the rent of land, and thereby obtains any money or other personal property from such landlord, and with like intent, without just cause, and without refunding such money, or paying

> for such property, refuses or fails to cultivate such land, or to comply with his contract relative thereto, must on conviction be punished by fine in double the damage suffered by the injured party, but not more than $300, one half of said fine to go to the county and one half to the party injured. And the refusal or failure of any person, who enters into such contract, to perform such act or service, or to cultivate such land, or refund such money, or pay for such property, without just cause, shall be prima facie evidence of the intent to injure his employer or landlord or defraud him. That all laws and parts of laws in conflict with the provisions hereof be and the same are hereby repealed.'

There is also a rule of evidence enforced by the courts of Alabama which must be regarded as having the same effect as if read into the statute itself, that the accused, for the purpose of rebutting the statutory presumption, shall not be allowed to testify 'as to his uncommunicated motives, purpose, or intention.' 161 Ala. 77, 78, 49 So. 886.

Bailey, the plaintiff in error, was committed for detention on the charge of obtaining $15 under a contract in writing with intent to injure or defraud his employer. He sued out a writ of habeas corpus, challenging the validity of the statute. His discharge was refused, and the supreme court of the state affirmed the order, holding the statute to be constitutional. 158 Ala. 18, 48 So. 498. On writ of error from this court it was held that the case was brought here prematurely, and the questions now presented were expressly reserved. Bailey v. Alabama, 211 U. S. 452, 53 L. ed. 278, 29 Sup. Ct. Rep. 141.

Having failed to obtain his release on habeas corpus, Bailey was indicted on the following charge:

> 'The grand jury of said county charge that before the finding of this indictment Alonzo Bailey, with intent to injure or defraud his employer, the Riverside Company, a corporation, entered into a written contract to perform labor or services for the Riverside Company, a corporation, and obtained thereby the sum of $15 from the said the Riverside Company, and afterwards with like intent, and without just cause, failed or refused to perform such labor or services, or to refund such money, against the peace and dignity of the state of Alabama.'

Motion to quash and a demurrer to the indictment were overruled. Upon the trial the following facts appeared: On December 26, 1907, Bailey entered into a written contract with the Riverside Company, which provided:

> 'That I, Lonzo Bailey, for and in consideration of the sum of $15 in money, this day in hand paid to me by said the Riverside Company, the receipt whereof I do hereby acknowledge, I, the said Lonzo Bailey, do hereby consent, contract, and agree to work and labor for the said Riverside Company as a farm hand on their Scott's Bend place in Montgomery county, Alabama, from the 30 day of December, 1907, to the 30 day of December, 1908, at and for the sum of $12 per month.
>
> 'And the said Lonzo Bailey agrees to render respectful and faithful service to the said the Riverside Company, and to perform diligently and actively all work pertaining to such employment, in accordance with the instructions of the said the Riverside Company or agent.

> 'And the said the Riverside Company, in consideration of the agreement above mentioned of the said Lonzo Bailey, hereby employs the said Lonzo Bailey as such farm hand for the time above set out, and agrees to pay the said Lonzo Bailey the sum of $10.75 per month.'

The manager of the employing company testified that at the time of entering into this contract there were present only the witness and Bailey, and that the latter then obtained from the company the sum of $15; that Bailey worked under the contract throughout the month of January and for three or four days in February, 1908, and then, 'without just cause, and without refunding the money, ceased to work for said Riverside Company, and has not since that time performed any service for said company in accordance with or under said contract, and has refused and failed to perform any further service thereunder, and has, without just cause, refused and failed to refund said $15.' He also testified, in response to a question from the attorney for the defendant, and against the objection of the state, that Bailey was a negro. No other evidence was introduced.

The court, after defining the crime in the language of the statute, charged the jury, in accordance with its terms, as follows:

> 'And the refusal of any person who enters into such contract to perform such act or service, or refund such money, or pay for such property, without just cause, shall be prima facie evidence of the intent to injure his employer, or to defraud him.'

Bailey excepted to these instructions, and requested the court to instruct the jury that the statute and the provision creating the presumption were invalid, and further that 'the refusal or failure of the defendant to perform the service alleged in the indictment, or to refund the money obtained from the Riverside Company under the contract between it and the defendant, without cause, does not of itself make out a prima facie case of the defendant's intent to injure or defraud said Riverside Company.'

The court refused these instructions and Bailey took exception.

The jury found the accused guilty, fixed the damages sustained by the injured party at $15, and assessed a fine of $30. Thereupon Bailey was sentenced by the court to pay the fine of $30 and the costs, and in default thereof to hard labor 'for twenty days in lieu of said fine, and one hundred and sixteen days on account of said costs.'

On appeal to the supreme court of the state, the constitutionality of the statute was again upheld and the judgment affirmed. 161 Ala. 75, 49 So. 886.

We at once dismiss from consideration the fact that the plaintiff in error is a black man. While the action of a state, through its officers charged with the administration of a law fair in appearance, may be of such a character as to constitute a denial of the equal protection of the laws (Yick Wo v. Hopkins, 118 U. S. 356, 373, 30 L. ed. 220, 227, 6 Sup. Ct. Rep. 1064), such a conclusion is here neither required nor justified. The statute, on its face, makes no racial discrimination, and the record fails to show its existence in fact. No question of a sectional character is presented, and we may view the legislation in the same manner as if it had been enacted in New York or in Idaho. Opportunities for coercion and oppression, in varying circumstances, exist in all parts of the Union, and the citizens of all the states are interested in the maintenance of the constitutional guaranties, the consideration of which is here involved.

Prior to the amendment of the year 1903, enlarged in 1907, the statute did not make the mere breach of the contract, under which the employee had obtained from his employer money which was not refunded or property which was not paid for, a crime. The essential ingredient of the offense was the intent of the accused to injure or defraud. To justify conviction, it was necessary that this intent should be established by competent evidence, aided only by such inferences as might logically be derived from the facts proved, and should not be the subject of mere surmise or arbitrary assumption.

This was the construction which the supreme court of Alabama placed upon the statute, as it then stood, in Ex parte Riley, 94 Ala. 82, 10 So. 528. In that case the court said (id. 83, 84):

> 'The ingredients of this statutory offense are: (1) A contract in writing by the accused for the performance of any act or service; (2) an intent on the part of the accused, when he entered into the contract, to injure or defraud his employer; (3) the obtaining by the accused of money or other personal property from such employer by means of such contract entered into with such intent; and (4) the refusal by the accused, with like intent, and without just cause, and without refunding such money, or paying for such property, to perform such act or service. This statute by no means provides that a person who has entered into a written contract for the performance of services, under which he has obtained money or other personal property, is punishable as if he had stolen such money or other personal property, upon his refusal to perform the contract, without refunding the money or paying for the property. A mere breach of a contract is not by the statute made a crime. The criminal feature of the transaction is wanting unless the accused entered into the contract with intent to injure or defraud his employer, and unless his refusal to perform was with like intent and without just cause. That there was an intent to injure or defraud the employer, both when the contract was entered into and when the accused refused performance, are facts which must be shown by the evidence. As the intent is the design, purpose, resolve, or determination in the mind of the accused, it can rarely be proved by direct evidence, but must be ascertained by means of inferences from the facts and circumstances developed by the proof. Carlisle v. State, 76 Ala. 75; Mack v. State, 63 Ala. 138. In the absence, however, of evidence from which such inferences may be drawn, the jury are not justified in indulging in mere unsupported conjectures, speculations, or suspicions as to intentions which were not disclosed by any visible or tangible act, expression, or circumstance. Green v. State, 68 Ala. 539.' See also Dorsey v. State, 111 Ala. 40, 20 So. 629; McIntosh v. State, 117 Ala. 128, 23 So. 668.

We pass, then, to the consideration of the amendment, through the operation of which under the charge of the trial court this conviction was obtained. No longer was it necessary for the prosecution to comply with the rule of the Riley Case (supra) in order to establish the intent to injure or defraud which, as the court said, constituted the gist of the offense. It was 'the difficulty in proving the intent, made patent by that decision,' which 'suggested the amendment of 1903.' Bailey v. State, 158 Ala. p. 25, 48 So. 498. By this amendment it was provided, in substance, that the refusal or failure to perform the service contracted for, or to refund the money obtained, without just cause, should be prima facie evidence of the intent to injure or defraud. But the refusal or failure to perform the service, without just cause, constitutes the breach of the contract. The justice of the grounds of refusal or failure must, of course, be determined by the contractual obligation

assumed. Whatever the reason for leaving the service, if, judged by the terms of the contract, it is insufficient in law, it is not 'just cause.' The money received and repayable, nothing more being shown, constitutes a mere debt. The asserted difficulty of proving the intent to injure or defraud is thus made the occasion for dispensing with such proof, so far as the prima facie case is concerned. And the mere breach of a contract for personal service, coupled with the mere failure to pay a debt which was to be liquidated in the course of such service, is made sufficient to warrant a conviction.

It is no answer to say that the jury must find, and here found, that a fraudulent intent existed. The jury by their verdict cannot add to the facts before them. If nothing be shown but a mere breach of a contract of service and a mere failure to pay a debt, the jury have nothing else to go upon, and the evidence becomes nothing more because of their finding. Had it not been for this statutory presumption, supplied by the amendment, no one would be heard to say that Bailey could have been convicted.

Prima facie evidence is sufficient evidence to outweigh the presumption of innocence, and if not met by opposing evidence, to support a verdict of guilty. 'It is such as, in judgment of law, is sufficient to establish the fact; and, if not rebutted, remains sufficient for the purpose.' Kelly v. Jackson, 6 Pet. 632, 8 L. ed. 526.

We are not impressed with the argument that the supreme court of Alabama has construed the amendment to mean that the jury is not controlled by the presumption, if unrebutted, and still may find the accused not guilty. That court, in its opinion, said: 'Again, it must be borne in mind that the rule of evidence fixed by the statute does not make it the duty of the jury to convict on the evidence referred to in the enactment, if unrebutted, whether satisfied thereby of the guilt of the accused beyond a reasonable doubt or not. On the contrary, with such evidence before them, the jury are still left free to find the accused guilty or not guilty, according as they may be satisfied of his guilt or not, by the whole evidence.' 161 Ala. 78, 49 So. 886.

But the controlling construction of the statute is the affirmance of this judgment of conviction. It is not sufficient to declare that the statute does not make it the duty of the jury to convict, where there is no other evidence but the breach of the contract and the failure to pay the debt. The point is that, in such a case, the statute authorizes the jury to convict. It is not enough to say that the jury may not accept that evidence as alone sufficient; for the jury may accept it, and they have the express warrant of the statute to accept it as a basis for their verdict. And it is in this light that the validity of the statute must be determined.

It is urged that the time and circumstances of the departure from service may be such as to raise not only an inference, but a strong inference, of fraudulent intent. There was no need to create a statutory presumption, and it was not created for such a case. Where circumstances are shown permitting a fair inference of fraudulent purpose, the case falls within the rule of Ex parte Riley (supra), which governed prosecutions under the statute before the amendment was made. The 'difficulty,' which admittedly the amendment was intended to surmount, did not exist where natural inferences sufficed. Plainly, the object of the statute was to hit cases which were destitute of such inferences, and to provide that the mere breach of the contract and the mere failure to pay the debt might do duty in their absence.

While, in considering the natural operation and effect of the statute, as amended, we are not limited to the particular facts of the case at the bar, they present an illuminating illustration. We may briefly restate them. Bailey made a contract to work for a year at $12 a month. He received $15, and he was to work this out,

being entitled monthly only to $10.75 of his wages. No one was present when he made the contract but himself and the manager of the employing company. There is not a particle of evidence of any circumstance indicating that he made the contract or received the money with any intent to injure or defraud his employer. On the contrary, he actually worked for upwards of a month. His motive in leaving does not appear, the only showing being that it was without legal excuse and that he did not repay the money received. For this he is sentenced to a fine of $30 and to imprisonment at hard labor, in default of the payment of the fine and costs, for 136 days. Was not the case the same in effect as if the statute had made it a criminal act to leave the service without just cause and without liquidating the debt? To say that he has been found guilty of an intent to injure or defraud his employer, and not merely for breaking his contract and not paying his debt, is a distinction without a difference to Bailey.

Consider the situation of the accused under this statutory presumption. If, at the outset, nothing took place but the making of the contract and the receipt of the money, he could show nothing else. If there was no legal justification for his leaving his employment, he could show none. If he had not paid the debt, there was nothing to be said as to that. The law of the state did not permit him to testify that he did not intend to injure or defraud. Unless he were fortunate enough to be able to command evidence of circumstances affirmatively showing good faith, he was helpless. He stood, stripped by the statute of the presumption of innocence, and exposed to conviction for fraud upon evidence only of breach of contract and failure to pay.

It is said that we may assume that a fair jury would convict only where the circumstances sufficiently indicated a fraudulent intent. Why should this be assumed in the face of the statute and upon this record? In the present case the jury did convict, although there is an absence of evidence sufficient to establish fraud under the familiar rule that fraud will not be presumed, and the obvious explanation of the verdict is that the trial court, in accordance with the statute, charged the jury that refusal to perform the service, or to repay the money, without just cause, constituted prima facie evidence of the commission of the offense which the statute defined. That is, the jury were told in effect that the evidence, under the statutory rule, was sufficient, and hence they treated it as such. There is no basis for an assumption that the jury would have acted differently if Bailey had worked for three months, or six months, or nine months, if in fact his debt had not been paid. The normal assumption is that the jury will follow the statute, and, acting in accordance with the authority it confers, will accept as sufficient what the statute expressly so describes.

It may further be observed that under the statute, there is no punishment for the alleged fraud if the service is performed or the money refunded. If the service is rendered in liquidation of the debt, there is no punishment; and if it is not rendered, and the money is not refunded, that fact alone is sufficient for conviction. By a statute passed by the legislature of Alabama in 1901, it was made a misdemeanor for any person who had made a written contract to labor for or serve another for any given time, to leave the service before the expiration of the contract, and without the consent of the employer, and to make a second contract of similar nature with another person without giving the second employer notice of the existence of the first contract. This was held unconstitutional upon the ground that it interfered with freedom of contract. Toney v. State, 141 Ala. 120, 67 L.R.A. 286, 109 Am. St. Rep. 23, 37 So. 332, 3 A. & E. Ann. Cas. 319. But, judging it by its necessary operation and obvious effect, the fundamental purpose plainly was to compel, under the sanction of the criminal law, the enforcement of the contract for personal service, and the same purpose, tested by like criteria, breathes despite its different phraseology through the amendments of 1903 and 1907 of the statute here in question.

We cannot escape the conclusion that, although the statute in terms is to punish fraud, still its natural and inevitable effect is to expose to conviction for crime those who simply fail or refuse to perform contracts for personal service in liquidation of a debt; and judging its purpose by its effect, that it seeks in this way to provide the means of compulsion through which performance of such service may be secured. The question is whether such a statute is constitutional.

This court has frequently recognized the general power of every legislature to prescribe the evidence which shall be received, and the effect of that evidence, in the courts of its own government. Fong Yue Ting v. United States, 149 U. S. 698, 479, 37 L. ed. 905, 925, 13 Sup. Ct. Rep. 1016. In the exercise of this power numerous statutes have been enacted providing that proof of one fact shall be prima facie evidence of the main fact in issue; and where the inference is not purely arbitrary, and there is a rational relation between the two facts, and the accused is not deprived of a proper opportunity to submit all the facts bearing upon the issue, it has been held that such statutes do not violate the requirements of due process of law. Adams v. New York, 192 U. S. 585, 48 L. ed. 575, 24 Sup. Ct. Rep. 372; Mobile, J. & K. C. R. Co. v. Turnipseed, decided by this court December 19, 1910 [219 U. S. 35, 55 L. ed. 78, 31 Sup. Ct. Rep. 136].

The latest expression upon this point is found in the case last cited, where the court, by Mr. Justice Lurton, said: 'That a legislative presumption of one fact from evidence of another may not constitute a denial of due process of law, or a denial of the equal protection of the law, it is only essential that there shall be some rational connection between the fact proved and the ultimate fact presumed, and that the inference of one fact from proof of another shall not be so unreasonable as to be a purely arbitrary mandate. So, also, it must not, under guise of regulating the presentation of evidence, operate to preclude the party from the right to present his defense to the main fact thus presumed. If a legislative provision not unreasonable in itself, prescribing a rule of evidence, in either criminal or civil cases, does not shut out from the party affected a reasonable opportunity to submit to the jury in his defense all of the facts bearing upon the issue, there is no ground for holding that due process of law has been denied him.'

In this class of cases where the entire subject-matter of the legislation is otherwise within state control, the question has been whether the prescribed rule of evidence interferes with the guaranteed equality before the law, or violates those fundamental rights and immutable principles of justice which are embraced within the conception of due process of law. But where the conduct or fact, the existence of which is made the basis of the statutory presumption, itself falls within the scope of a provision of the Federal Constitution, a further question arises. It is apparent that a constitutional prohibition cannot be transgressed indirectly by the creation of a statutory presumption any more than it can be violated by direct enactment. The power to create presumptions is not a means of escape from constitutional restrictions. And the state may not in this way interfere with matters withdrawn from its authority by the Federal Constitution, or subject an accused to conviction for conduct which it is powerless to proscribe.

In the present case it is urged that the statute as amended, through the operation of the presumption for which it provides, violates the 13th Amendment of the Constitution of the United States and the act of Congress passed for its enforcement.

The 13th Amendment provides:

> 'Section 1. Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.
>
> 'Section 2. Congress shall have power to enforce this article by appropriate legislation.'

Pursuant to the authority thus conferred, Congress passed the act of March 2, 1867, chap. 187, 14 Stat. at L. 546, the provisions of which are now found in §§ 1990 and 5526 of the Revised Statutes (U. S. Comp. Stat. 1901, pp. 1266, 3715), as follows:

> 'Sec. 1990. The holding of any person to service or labor under the system known as peonage is abolished and forever prohibited in the territory of New Mexico, or in any other territory or state of the United States; and all acts, laws, resolutions, orders, regulations, or usages of the territory of New Mexico, or of any other territory or state, which have heretofore established, maintained, or enforced, or by virtue of which any attempt shall hereafter be made to establish, maintain, or enforce, directly or indirectly, the voluntary or involuntary service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise, are declared null and void.'
>
> 'Sec. 5526. Every person who holds, arrests, returns, or causes to be held, arrested, or returned, or in any manner aids in the arrest or return, of any person to a condition of peonage, shall be punished by a fine of not less than one thousand nor more than five thousand dollars, or by imprisonment not less than one year nor more than five years, or by both.'

The language of the 13th Amendment was not new. It reproduced the historic words of the ordinance of 1787 for the government of the Northwest territory, and gave them unrestricted application within the United States and all places subject to their jurisdiction. While the immediate concern was with African slavery, the Amendment was not limited to that. It was a charter of universal civil freedom for all persons, of whatever race, color, or estate, under the flag.
The words involuntary servitude have a 'larger meaning than slavery.'

'It was very well understood that, in the form of apprenticeship for long terms, as it had been practiced in the West India Islands, on the abolition of slavery by the English government, or by reducing the slaves to the condition of serfs attached to the plantation, the purpose of the article might have been evaded, if only the word 'slavery' had been used.' Slaughter-House Cases, 16 Wall. p. 69, 21 L. ed. 406. The plain intention was to abolish slavery of whatever name and form and all its badges and incidents; to render impossible any state of bondage; to make labor free, by prohibiting that control by which the personal service of one man is disposed of or coerced for another's benefit, which is the essence of involuntary servitude.

While the Amendment was self-executing, so far as its terms were applicable to any existing condition, Congress was authorized to secure its complete enforcement by appropriate legislation. As was said in the Civil Rights Cases: 'By its own unaided force and effect it abolished slavery, and established universal freedom. Still, legislation may be necessary and proper to meet all the various cases and circumstances to be

affected by it, and to prescribe proper modes of redress for its violation in letter or spirit. And such legislation may be primary and direct in its character; for the Amendment is not a mere prohibition of state laws establishing or upholding slavery, but an absolute declaration that slavery or involuntary servitude shall not exist in any part of the United States.' 109 U. S. 20, 27 L. ed. 842, 3 Sup. Ct. Rep. 18.

The act of March 2, 1867 (Rev. Stat. §§ 1990 and 5526, supra), a was a valid exercise of this express authority. Clyatt v. United States, 197 U. S. 207, 49 L. ed. 726, 25 Sup. Ct. Rep. 429. It declared that all laws of any state, by virtue of which any attempt should be made 'to establish, maintain, or enforce, directly or indirectly, the voluntary or involuntary service or labor of any person as peons, in liquidation of any debt or obligation, or otherwise,' should be null and void.

Peonage is a term descriptive of a condition which has existed in Spanish America, and especially in Mexico. The essence of the thing is compulsory service in payment of a debt. A peon is one who is compelled to work for his creditor until his debt is paid. And in this explicit and comprehensive enactment, Congress was not concerned with mere names or manner of description, or with a particular place or section of the country. It was concerned with a fact, wherever it might exist; with a condition, however named and wherever it might be established, maintained, or enforced.

The fact that the debtor contracted to perform the labor which is sought to be compelled does not withdraw the attempted enforcement from the condemnation of the statute. The full intent of the constitutional provision could be defeated with obvious facility if, through the guise of contracts under which advances had been made, debtors could be held to compulsory service. It is the compulsion of the service that the statute inhibits, for when that occurs, the condition of servitude is created, which would be not less involuntary because of the original agreement to work out the indebtedness. The contract exposes the debtor to liability for the loss due to the breach, but not to enforced labor. This has been so clearly stated by this court in the case of Clyatt, supra, that discussion is unnecessary. The court there said:

'The constitutionality and scope of §§ 1990 and 5526 present the first questions for our consideration. They prohibit peonage. What is peonage? It may be defined as a status or condition of compulsory service, based upon the indebtedness of the peon to the master. The basal fact is indebtedness. As said by Judge Benedict, delivering the opinion in Jaremillo v. Romero, 1 N. M. 190, 194: 'One fact existed universally; all were indebted to their masters. This was the cord by which they seemed bound to their masters' service.' Upon this is based a condition of compulsory service. Peonage is sometimes classified as voluntary or involuntary, but this implies simply a difference in the mode of origin, but none in the character of the servitude. The one exists where the debtor voluntarily contracts to enter the service of his creditor. The other is forced upon the debtor by some provision of law. But peonage, however created, is compulsory service, involuntary servitude. The peon can release himself therefrom, it is true, by the payment of the debt, but otherwise the service is enforced. A clear distinction exists between peonage and the voluntary performance of labor or rendering of services in payment of a debt. In the latter case the debtor, though contracting to pay his indebtedness by labor or service, and subject like any other contractor to an action for damages for breach of that contract, can elect at any time to break it, and no law or force compels performance or a continuance of the service. We need not stop to consider any possible limits or exceptional cases, such as the service of a sailor (Robertson v. Baldwin, 165 U. S. 275, 41 L. ed. 715, 17 Sup. Ct. Rep. 326), or the obligations of a child to its parents, or of an apprentice to his master, or the power of the legislature to make unlawful and

punish criminally an abandonment by an employee of his post of labor in any extreme cases. That which is contemplated by the statute is compulsory service to secure the payment of a debt.' 197 U. S. pp. 215, 216.

The act of Congress, nullifying all state laws by which it should be attempted to enforce the 'service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise,' necessarily embraces all legislation which seeks to compel the service or labor by making it a crime to refuse or fail to perform it. Such laws would furnish the readiest means of compulsion. The 13th Amendment prohibits involuntary servitude except as punishment for crime. But the exception, allowing full latitude for the enforcement of penal laws, does not destroy the prohibition. It does not permit slavery or involuntary servitude to be established or maintained through the operation of the criminal law by making it a crime to refuse to submit to the one or to render the service which would constitute the other. The state may impose involuntary servitude as a punishment for crime, but it may not compel one man to labor for another in payment of a debt, by punishing him as a criminal if he does not perform the service or pay the debt.

If the statute in this case had authorized the employing company to seize the debtor, and hold him to the service until he paid the $15, or had furnished the equivalent in labor, its invalidity would not be questioned. It would be equally clear that the state could not authorize its constabulary to prevent the servant from escaping, and to force him to work out his debt. But the state could not avail itself of the sanction of the criminal law to supply the compulsion any more than it could use or authorize the use of physical force. 'In contemplation of the law, the compulsion to such service by the fear of punishment under a criminal statute is more powerful than any guard which the employer could station.' Ex parte Hollman, 79 S. C. 22, 21 L.R.A.(N. S.) 249, 60 S. E. p. 24, 14 A. & E. Ann. Cas. 1109.

What the state may not do directly it may not do indirectly. If it cannot punish the servant as a criminal for the mere failure or refusal to serve without paying his debt, it is not permitted to accomplish the same result by creating a statutory presumption which, upon proof of no other fact, exposes him to conviction and punishment. Without imputing any actual motive to oppress, we must consider the natural operation of the statute here in question (Henderson v. New York [Henderson v. Wickham] 92 U. S. p. 268, 23 L. ed. 547), and it is apparent that it furnishes a convenient instrument for the coercion which the Constitution and the act of Congress forbid; an instrument of compulsion peculiarly effective as against the poor and the ignorant, its most likely victims. There is no more important concern than to safeguard the freedom of labor upon which alone can enduring prosperity be based. The provision designed to secure it would soon become a barren form if it were possible to establish a statutory presumption of this sort, and to hold over the heads of laborers the threat of punishment for crime, under the name of fraud, but merely upon evidence of failure to work out their debts. The act of Congress deprives of effect all legislative measures of any state through which, directly or indirectly, the prohibited thing, to wit, compulsory service to secure the payment of a debt, may be established or maintained; and we conclude that § 4730, as amended, of the Code of Alabama, in so far as it makes the refusal or failure to perform the act or service, without refunding the money or paying for the property prima facie evidence of the commission received of the crime which the section defines, is in conflict with the 13th Amendment, and the legislation authorized by that Amendment, and is therefore invalid.

In this view it is unnecessary to consider the contentions which have been made under the 14th Amendment. As the case was given to the jury under instructions which authorized a verdict in accordance with the

statutory presumption, and the opposing instructions requested by the accused were refused, the judgment must be reversed.

Reversed and cause remanded for further proceedings not inconsistent with this opinion.

Mr. Justice Holmes, dissenting:

We all agree that this case is to be considered and decided in the same way as if it arose in Idaho or New York. Neither public document nor evidence discloses a law which, by its administration, is made something different from what it appears on its face, and therefore the fact that in Alabama it mainly concerns the blacks does not matter. Yick Wo v. Hopkins, 118 U. S. 356, 30 L. ed. 220, 6 Sup. Ct. Rep. 1064, does not apply. I shall begin, then, by assuming for the moment what I think is not true, and shall try to show not to be true, that this statute punishes the mere refusal to labor according to contract as a crime, and shall inquire whether there would be anything contrary to the 13th Amendment or the statute if it did, supposing it to have been enacted in the state of New York. I cannot believe it. The 13th Amendment does not outlaw contracts for labor. That would be at least as great a misfortune for the laborer as for the man that employed him. For it certainly would affect the terms of the bargain unfavorably for the laboring man if it were understood that the employer could do nothing in case the laborer saw fit to break his word. But any legal liability for breach of a contract is a disagreeable consequence which tends to make the contractor do as he said he would. Liability to an action for damages has that tendency as well a fine. If the mere imposition of such consequences as tend to make a man keep to his promise is the creation of peonage when the contract happens to be for labor, I do not see why the allowance of a civil action is not, as well as an indictment ending in fine. Peonage is service to a private master at which a man is kept by bodily compulsion against his will. But the creation of the ordinary legal motives for right conduct does not produce it. Breach of a legal contract without excuse is wrong conduct, even if the contract is for labor; and if a state adds to civil liability a criminal liability to fine, it simply intensifies the legal motive for doing right; it does not make the laborer a slave.

But if a fine may be imposed, imprisonment may be imposed in case of a failure to pay it. Nor does it matter if labor is added to the imprisonment. Imprisonment with hard labor is not stricken from the statute books. On the contrary, involuntary servitude as a punishment for crime is excepted from the prohibition of the 13th Amendment in so many words. Also the power of the states to make breach of contract a crime is not done away with by the abolition of slavery. But if breach of contract may be made a crime at all, it may be made a crime with all the consequences usually attached to crime. There is produced a sort of illusion if a contract to labor ends in compulsory labor in a prison. But compulsory work for no private master in a jail is not peonage. If work in a jail is not condemned in itself, without regard to what the conduct is it punishes, it may be made a consequence of any conduct that the state has power to punish at all. I do not blink the fact that the liability to imprisonment may work as a motive when a fine without it would not, and that it may induce the laborer to keep on when he would like to leave. But it does not strike me as an objection to a law that it is effective. If the contract is one that ought not to be made, prohibit it. But if it is a perfectly fair and proper contract, I can see no reason why the state should not throw its weight on the side of performance. There is no relation between its doing so in the manner supposed, and allowing a private master to use private force upon a laborer who wishes to leave.

But all that I have said so far goes beyond the needs of the case as I understand it. I think it a mistake to say

that this statute attaches its punishment to the mere breach of a contract to labor. It does not purport to do so; what it purports to punish is fraudulently obtaining money by a false pretense of an intent to keep the written contract in consideration of which the money is advanced. (It is not necessary to cite cases to show that such an intent may be the subject of a material false representation.) But the import of the statute is supposed to be changed by the provision, that a refusal to perform, coupled with a failure to return the money advanced, shall be prima facie evidence of fraudulent intent. I agree that if the statute created a conclusive presumption, it might be held to make a disguised change in the substantive law. Keller v. United States, 213 U. S. 138, 150, 53 L. ed. 737, 741, 29 Sup. Ct. Rep. 470, 16 A. & E. Ann. Cas. 1066. But it only makes the conduct prima facie evidence,--a very different matter. Is it not evidence that a man had a fraudulent intent if he receives an advance upon a contract over night and leaves in the morning? I should have thought that it very plainly was. Of course, the statute is in general terms, and applies to a departure at any time without excuse or repayment, but that does no harm except on a tacit assumption that this law is not administered as it would be in New York, and that juries will act with prejudice against the laboring man. For prima facie evidence is only evidence, and as such may be held by the jury insufficient to make out guilt. 161 Ala. 78, 49 So. 886. This was decided by the supreme court of Alabama in this case, and we should be bound by their construction of the statute, even if we thought it wrong. But I venture to add that I think it entirely right. State v. Intoxicating Liquors, 80 Me. 57, 12 Atl. 794, 7 Am. Crim. Rep. 291. This being so, I take it that a fair jury would acquit, if the only evidence were a departure after eleven months' work, and if it received no color from some special well-known course of events. But the matter well may be left to a jury, because their experience as men of the world may teach them that in certain conditions it is so common for laborers to remain during a part of the season, receiving advances, and then to depart at the period of need, in the hope of greater wages at a neighboring plantation, that when a laborer follows that course there is a fair inference of fact that he intended it from the beginning. The Alabama statute, as construed by the state court and as we must take it, merely says, as a court might say, that the prosecution may go to the jury. This means, and means only, that the court cannot say, from its knowledge of the ordinary course of events, that the jury could not be justified by its knowledge in drawing the inference from the facts proved. In my opinion, the statute embodies little if anything more than what I should have told the jury was the law without it. The right of the state to regulate laws of evidence is admitted, and the statute does not go much beyond the common law. Com. v. Rubin, 165 Mass. 453, 43 N. E. 200.

I do not see how the result that I have reached thus far is affected by the rule laid down by the court, but not contained in the statute, that the prisoner cannot testify to his uncommunicated intentions, and therefore, it is assumed, would not be permitted to offer a naked denial of an intent to defraud. If there is an excuse for breaking the contract, it will be found in external circumstances, and can be proved. So the sum of the wrong supposed to be inflicted is that the intent to go off without repaying may be put further back than it would be otherwise. But if there is a wrong it lies in leaving the evidence to the jury,--a wrong that is not affected by the letting in or keeping out an item of evidence on the other side. I have stated why I think it was not a wrong.

To sum up, I think that obtaining money by fraud may be made a crime as well as murder or theft; that a false representation, expressed or implied, at the time of making a contract of labor, that one intends to perform it, and thereby obtaining an advance, may be declared a case of fraudulently obtaining money as well as any other; that if made a crime it may be punished like any other crime; and that an unjustified departure from the promised service without repayment may be declared a sufficient case to go to the jury for their judgment; all without in any way infringing the 13th Amendment or the statutes of the United States.

Mr. Justice Lurton concurs in this dissent.

United States v. Kozminski, 487 U.S. 931, 108 S.Ct. 2751 (1988)

Supreme Court of the United States

UNITED STATES, Petitioner
v.
Ike KOZMINSKI et al.

No. 86-2000.

Decided June 29, 1988.

Defendants were convicted in the United States District Court for the Eastern District of Michigan of holding two retarded farm workers in involuntary servitude and of conspiring to deprive them of constitutional right to be free from involuntary servitude. Another defendant was convicted on conspiracy charge. Defendants appealed. The Court of Appeals, 821 F.2d 1186, reversed and remanded. Certiorari was granted. The Supreme Court, O'Connor, J., held that: (1) involuntary servitude means condition of servitude in which victim is forced to work for defendant by use or threat of physical restraint or injury or by use or threat of coercion through law or legal process, and (2) district court's instruction defining involuntary servitude so that it would encompass psychological coercion required reversal of convictions.

Court of Appeals affirmed, and case remanded.

Brennan, J., concurred in judgment and filed opinion joined by Marshall, J.

Stevens, J., concurred in judgment and filed opinion joined by Blackmun, J.

Syllabus (FN*)

After two mentally retarded men were found laboring on respondents' farm in poor health, in squalid conditions, and in relative isolation from the rest of society, respondents were charged with violating 18 U.S.C. § 241 by conspiring to prevent the men from exercising their Thirteenth Amendment right to be free from involuntary servitude, and with violating 18 U.S.C. § 1584 by knowingly holding the men in involuntary servitude. At respondents' trial in Federal District Court, the Government's evidence indicated, inter alia, that the two men worked on the farm seven days a week, often 17 hours a day, at first for $15 per week and eventually for no pay, and that, in addition to actual or threatened physical abuse and a threat to reinstitutionalize one of the men if he did not do as he was told, respondents had used various forms of psychological coercion to keep the men on the farm. The court

instructed the jury that, under both statutes, involuntary servitude may include situations involving any "means of compulsion ..., sufficient in kind and degree, to subject a person having the same general station in life as the alleged victims to believe they had no reasonable means of escape and no choice except to remain in the service of the employer." The jury found respondents guilty, and the court imposed sentences. However, the Court of Appeals reversed and remanded for a new trial, concluding that the trial court's definition of involuntary servitude was too broad in that it included general psychological coercion. The court held that involuntary servitude exists only when the master subjects the servant to (1) threatened or actual physical force, (2) threatened or actual state imposed legal coercion, or (3) fraud or deceit where the servant is a minor or an immigrant or is mentally incompetent.

Held: For purposes of criminal prosecution under § 241 or § 1584, the term "involuntary servitude" necessarily means a condition of servitude in which the victim is forced to work for the defendant by the use or threat of physical restraint or physical injury or by the use or threat of coercion through law or the legal process. This definition encompasses cases in which the defendant holds the victim in servitude by placing him or her in fear of such physical restraint or injury or legal coercion. Pp. 2758-2765.

(a) The Government cannot prove a § 241 conspiracy to violate rights secured by the Thirteenth Amendment without proving that the conspiracy involved the use or threatened use of physical or legal coercion. The fact that the Amendment excludes from its prohibition involuntary servitude imposed "as a punishment for crime whereof the party shall have been duly convicted" indicates that the Amendment's drafters thought that involuntary servitude generally includes situations in which the victim is compelled to work by law. Moreover, the facts that the phrase "involuntary servitude" was intended "to cover those forms of compulsory labor akin to African slavery," Butler v. Perry, 240 U.S. 328, 332, 36 S.Ct. 258, 259, 60 L.Ed. 672, and that the Amendment extends beyond state action, cf. U.S. Const., Amdt. 14, § 1, imply an intent to prohibit compulsion through physical coercion. These assessments are confirmed by this Court's decisions construing the Amendment, see, e.g., Clyatt v. United States, 197 U.S. 207, 25 S.Ct. 429, 49 L.Ed. 726, which have never interpreted the guarantee of freedom from involuntary servitude to specifically prohibit compulsion of labor by other means, such as psychological coercion. Pp. 2759-2761.

(b) The language and legislative history of § 1584 and its statutory progenitors indicate that its reach should be limited to cases involving the compulsion of services by the use or threatened use of physical or legal coercion. That is the understanding of the Thirteenth Amendment's "involuntary servitude" phrase that prevailed at the time of § 1584's enactment and, since Congress clearly borrowed that phrase in enacting § 1584, the phrase

should have the same meaning in both places absent any contrary indications. Section 1584's history undercuts the contention that Congress had a broader concept of involuntary servitude in mind when it enacted the statute, and does not support the Court of Appeals' conclusion that immigrants, children, and mental incompetents are entitled to any special protection. Pp. 2761-2763.

(c) The Government's broad construction of "involuntary servitude"--which would prohibit the compulsion of services by any type of speech or intentional conduct that, from the victim's point of view, either leaves the victim with no tolerable alternative but to serve the defendant or deprives the victim of the power of choice--could not have been intended by Congress. That interpretation would appear to criminalize a broad range of day-to-day activity; would delegate to prosecutors and juries the inherently legislative task of determining what type of coercive activities are so morally reprehensible that they should be punished as crimes; would subject individuals to the risk of arbitrary or discriminatory prosecution and conviction; and would make the type of coercion prohibited depend entirely on the victim's state of mind, thereby depriving ordinary people of fair notice of what is required of them. These defects are not cured by the Government's ambiguous specific intent requirement. Justice BRENNAN's position--that § 1584 prohibits any means of coercion that actually succeeds in reducing the victim to a condition of servitude resembling that in which antebellum slaves were held--although theoretically narrower than the Government's interpretation, suffers from the same flaws. Justice STEVENS' conclusion that Congress intended to delegate to the Judiciary the task of defining "involuntary servitude" on a case-by-case basis is unsupported and could lead to the arbitrary and unfair imposition of criminal punishment. The purposes underlying the rule of lenity for interpreting ambiguous statutory provisions are served by construing § 241 and § 1584 to prohibit only compulsion of services through physical or legal coercion. Pp. 2763-2764.

(d) The latter construction does not imply that evidence of other means of coercion, or of extremely poor working conditions, or of the victim's special vulnerabilities, is irrelevant. The victim's vulnerabilities are relevant in determining whether the physical or legal coercion or threats thereof could plausibly have compelled the victim to serve. Moreover, a trial court could properly find that evidence of other means of coercion or of poor working conditions is relevant to corroborate disputed evidence regarding the use or threats of physical or legal coercion, the defendant's intent in using such means, or the causal effect of such conduct. P. 2764.

(e) Since the District Court's jury instructions encompassed means of coercion other than actual or threatened physical or legal coercion, the instructions may have caused respondents to be convicted for conduct that does not violate § 241 or § 1584. The

convictions must therefore be reversed. Because the record contains sufficient evidence of physical or legal coercion to permit a conviction, however, a judgment of acquittal is unwarranted, and the case is remanded for further proceedings consistent with this opinion. P. 2765.

821 F.2d 1186 (CA6 1987), affirmed and remanded.

O'CONNOR, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and WHITE, SCALIA, and KENNEDY, JJ., joined. BRENNAN, J., filed an opinion concurring in the judgment, in which MARSHALL, J., joined, post, p. ---. STEVENS, J., filed an opinion concurring in the judgment, in which BLACKMUN, J., joined, post, p. ---.

Justice O'CONNOR delivered the opinion of the Court.

This case concerns the scope of two criminal statutes enacted by Congress to enforce the Thirteenth Amendment. Title 18 U.S.C. § 241 prohibits conspiracy to interfere with an individual's Thirteenth Amendment right to be free from "involuntary servitude." Title 18 U.S.C. § 1584 makes it a crime knowingly and willfully to hold another person "to involuntary servitude." We must determine the meaning of "involuntary servitude" under these two statutes.

I

In 1983, two mentally retarded men were found laboring on a Chelsea, Michigan, dairy farm in poor health, in squalid conditions, and in relative isolation from the rest of society. The operators of the farm--Ike Kozminski, his wife Margarethe, and their son John--were charged with violating 18 U.S.C. § 241 by conspiring to "injure, oppress, threaten, or intimidate" the two men in the free exercise and enjoyment of their federal right to be free from involuntary servitude. The Kozminskis were also charged with knowingly holding, or aiding and abetting in the holding of, the two men to involuntary servitude in violation of 18 U.S.C. § 1584 and § 2. (FN1) The case was tried before a jury in the United States District Court for the Eastern District of Michigan. The Government's evidence is summarized below.

The victims, Robert Fulmer and Louis Molitoris, have intelligence quotients of 67 and 60 respectively. Though chronologically in their 60's during the period in question, they viewed the world and responded to authority as would someone of 8 to 10 years. Margarethe Kozminski picked Fulmer up one evening in 1967 while he was walking down the road, and brought him to work at one of the Kozminski farms. He was working on another farm at the time, but Mrs. Kozminski simply left a note telling his former employer

that he had gone. Molitoris was living on the streets of Ann Arbor, Michigan, in the early 1970's when Ike Kozminski brought him to work on the Chelsea farm. He had previously spent several years at a state mental hospital.

Fulmer and Molitoris worked on the Kozminskis' dairy farm seven days a week, often 17 hours a day, at first for $15 per week and eventually for no pay. The Kozminskis subjected the two men to physical and verbal abuse for failing to do their work and instructed herdsmen employed at the farm to do the same. The Kozminskis directed Fulmer and Molitoris not to leave the farm, and on several occasions when the men did leave, the Kozminskis or their employees brought the men back and discouraged them from leaving again. On one occasion, John Kozminski threatened Molitoris with institutionalization if he did not do as he was told.

The Kozminskis failed to provide Fulmer and Molitoris with adequate nutrition, housing, clothing, or medical care. They directed the two men not to talk to others and discouraged the men from contacting their relatives. At the same time, the Kozminskis discouraged relatives, neighbors, farm-hands, and visitors from contacting Fulmer and Molitoris. Fulmer and Molitoris asked others for help in leaving the farm, and eventually a herdsman hired by the Kozminskis was concerned about the two men and notified county officials of their condition. County officials assisted Fulmer and Molitoris in leaving the farm and placed them in an adult foster care home.

In attempting to persuade the jury that the Kozminskis held their victims in involuntary servitude, the Government did not rely solely on evidence regarding their use or threatened use of physical force or the threat of institutionalization. Rather, the Government argued that the Kozminskis had used various coercive measures--including denial of pay, subjection to substandard living conditions, and isolation from others--to cause the victims to believe they had no alternative but to work on the farm. The Government argued that Fulmer and Molitoris were "psychological hostages" whom the Kozminskis had "brainwash [ed]" into serving them. Tr. 15, 23. (FN2)

At the conclusion of the evidence, the District Court instructed the jurors that in order to convict the Kozminskis of conspiracy under § 241, they must find (1) the existence of a conspiracy including the Kozminskis, (2) that the purpose of the conspiracy was to injure, oppress, threaten or intimidate a United States citizen in the free exercise or enjoyment of a federal right to be free from involuntary servitude, and (3) that one of the conspirators knowingly committed an overt act in furtherance of that purpose. The court further instructed the jury that § 1584 required the Government to prove (1) that the Kozminskis held the victims in involuntary servitude, (2) that they acted knowingly or willfully, and (3) that their actions were a necessary cause of the victims' decision to continue working for

them. The court delivered the following instruction on the meaning of involuntary servitude under both statutes:

> "Involuntary servitude consists of two terms.
>
> "Involuntary means 'done contrary to or without choice'--'compulsory'--'not subject to control of the will.'
>
> "Servitude means '[a] condition in which a person lacks liberty especially to determine one's course of action or way of life'--'slavery'--'the state of being subject to a master.'
>
> "Involuntary servitude involves a condition of having some of the incidents of slavery.
>
> "It may include situations in which persons are forced to return to employment by law.
>
> "It may also include persons who are physically restrained by guards from leaving employment.
>
> "It may also include situations involving either physical and other coercion, or a combination thereof, used to detain persons in employment.

.....

* * *

"In other words, based on all the evidence it will be for you to determine if there was a means of compulsion used, sufficient in kind and degree, to subject a person having the same general station in life as the alleged victims to believe they had no reasonable means of escape and no choice except to remain in the service of the employer." App. to Pet. for Cert. 109a-110a.

So instructed, the jury found Ike and Margarethe Kozminski guilty of violating both statutes. John Kozminski was convicted only on the § 241 charge. Each of the Kozminskis was placed on probation for two years. In addition, Ike Kozminski was fined $20,000 and was ordered to pay $6,190.80 in restitution to each of the victims. John Kozminski was fined $10,000.

A divided panel of the Court of Appeals for the Sixth Circuit affirmed the convictions. App. to Pet. for Cert. 72a. After rehearing the case en banc, however, the Court of Appeals reversed the convictions and remanded the case for a new trial. 821 F.2d 1186 (1987). The majority concluded that the District Court's definition of involuntary servitude, which would bring cases involving general psychological coercion within the reach of § 241 and § 1584, was too broad. The court held that involuntary servitude exists only when

> "(a) the servant believes that he or she has no viable alternative but to perform service for the master (b) because of (1) the master's use or threatened use of physical force, or (2) the master's use or threatened use of state-imposed legal coercion (i.e., peonage), or (3) the master's use of fraud or deceit to obtain or maintain services where the servant is a minor, an immigrant or one who is mentally incompetent." 821 F.2d, at 1192 (footnote omitted).

The dissenting judges charged that the majority had "rewritten rather than interpreted" § 1584. Id., at 1213. They argued that involuntary servitude may arise from whatever means the defendant intentionally uses to subjugate the will of the victim so as to render the victim " 'incapable of making a rational choice.'" Id., at 1212-1213 (quoting United States v. Shackney, 333 F.2d 475, 488 (CA2 1964) (Dimock, J., concurring)).

The Court of Appeals' definition of involuntary servitude conflicts with the definitions adopted by other Courts of Appeals. Writing for the Second Circuit in United States v. Shackney, supra, Judge Friendly reasoned that

> "a holding in involuntary servitude means to us action by the master causing the servant to have, or to believe he has, no way to avoid continued service or confinement, ... not a situation where the servant knows he has a choice between continued service and freedom, even if the master has led him to believe that the choice may entail consequences that are exceedingly bad." Id., at 486.

Accordingly, Judge Friendly concluded that § 1584 prohibits only "service compelled by law, by force or by the threat of continued confinement of some sort." Id., at 487. See also United States v. Harris, 701 F.2d 1095, 1100 (CA4 1983) (involuntary servitude exists under § 241 and § 1584 where labor is coerced by "threat of violence or confinement, backed sufficiently by deeds"); United States v. Bibbs, 564 F.2d 1165, 1168 (CA5 1977) (involuntary servitude exists under § 1584 where the defendant places the victim "in such fear of physical harm that the victim is afraid to leave"). The Ninth Circuit, in contrast, has not limited the reach of § 1584 to cases involving physical force or legal sanction, but has concluded that

> "[a] holding in involuntary servitude occurs when an individual coerces another into his service by improper or wrongful conduct that is intended to

> cause, and does cause, the other person to believe that he or she has no alternative but to perform labor." United States v. Mussry, 726 F.2d 1448, 1453 (1984).

See also United States v. Warren, 772 F.2d 827, 833-834 (CA11 1985) ("Various forms of coercion may constitute a holding in involuntary servitude. The use, or threatened use, of physical force to create a climate of fear is the most grotesque example of such coercion").

We granted the Government's petition for a writ of certiorari, 484 U.S. 894, 108 S.Ct. 225, 98 L.Ed.2d 185 (1987), to resolve this conflict among the Courts of Appeals on the meaning of involuntary servitude for the purpose of criminal prosecution under § 241 and § 1584.

II

Federal crimes are defined by Congress, and so long as Congress acts within its constitutional power in enacting a criminal statute, this Court must give effect to Congress' expressed intention concerning the scope of conduct prohibited. See Dowling v. United States, 473 U.S. 207, 213, 214, 105 S.Ct. 3127, 3131, 3131-3132, 87 L.Ed.2d 152 (1985) (citing United States v. Wiltberger, 18 U.S. (5 Wheat.) 76, 95, 5 L.Ed. 37 (1820)). Congress' power to enforce the Thirteenth Amendment by enacting § 241 and § 1584 is clear and undisputed. See U.S. Const., Amdt. 13, § 2 ("Congress shall have power to enforce this article by appropriate legislation"); Griffin v. Breckenridge, 403 U.S. 88, 105, 91 S.Ct. 1790, 1800, 29 L.Ed.2d 338 (1971). The scope of conduct prohibited by these statutes is therefore a matter of statutory construction.

The Court of Appeals reached its conclusions regarding the meaning of involuntary servitude under both § 241 and § 1584 based solely on its analysis of the language and history of § 1584. A reading of these statutes, however, reveals an obvious difference between them. Unlike § 1584, which by its terms prohibits holding to involuntary servitude, § 241 prohibits conspiracies to interfere with rights secured "by the Constitution or laws of the United States," and thus incorporates the prohibition of involuntary servitude contained in the Thirteenth Amendment. See United States v. Price, 383 U.S. 787, 805, 86 S.Ct. 1152, 1162-1163, 16 L.Ed.2d 267 (1966). The indictment in this case, which was read to the jury, specifically charged the Kozminskis with conspiring to interfere with the "right and privilege secured ... by the Constitution and laws of the United States to be free from involuntary servitude as provided by the Thirteenth Amendment of the United States Constitution. " App. 177 (emphasis added). Thus, the indictment clearly specified a conspiracy to violate the Thirteenth Amendment. The indictment cannot be read to charge a conspiracy to violate § 1584 rather than the Thirteenth Amendment, because the criminal sanction imposed by § 1584 does not create any individual "right or privilege" as those

words are used in § 241. The Government has not conceded that the definition of involuntary servitude as used in the Thirteenth Amendment is limited by the meaning of the same phrase in § 1584. To the contrary, the Government argues (1) that the Thirteenth Amendment should be broadly construed, and (2) that Congress did not intend § 1584 to have a narrower scope. Brief for United States 22-32. The District Court defined involuntary servitude broadly under both § 241 and § 1584. The Court of Appeals reversed the convictions under both counts because it concluded that the definition of involuntary servitude given for each count was erroneous. Since the proper interpretation of each statute is squarely before us, we construe each statute separately to ascertain the conduct it prohibits.

A

Section 241 authorizes punishment when

> "two or more persons conspire to injure, oppress, threaten, or intimidate any citizen in the free exercise or enjoyment of any right or privilege secured to him by the Constitution or laws of the United States, or because of his having so exercised the same."

This Court interpreted the purpose and effect of § 241 over 20 years ago in United States v. Guest, 383 U.S. 745, 86 S.Ct. 1170, 16 L.Ed.2d 239 (1966), and United States v. Price, supra. Section 241 creates no substantive rights, but prohibits interference with rights established by the Federal Constitution or laws and by decisions interpreting them. Guest, supra, 383 U.S., at 754-755, 86 S.Ct., at 1176; Price, supra, 383 U.S., at 803, 86 S.Ct., at 1161. Congress intended the statute to incorporate by reference a large body of potentially evolving federal law. This Court recognized, however, that a statute prescribing criminal punishment must be interpreted in a manner that provides a definite standard of guilt. The Court resolved the tension between these two propositions by construing § 241 to prohibit only intentional interference with rights made specific either by the express terms of the Federal Constitution or laws or by decisions interpreting them. Price, supra, 383 U.S., at 806, n. 20, 86 S.Ct., at 1163, n. 20; Guest, supra, 383 U.S., at 754-755, 86 S.Ct., at 1176. Cf. Screws v. United States, 325 U.S. 91, 102, 65 S.Ct. 1031, 1036, 89 L.Ed. 1495 (1945).

The Kozminskis were convicted under § 241 for conspiracy to interfere with the Thirteenth Amendment guarantee against involuntary servitude. Applying the analysis set out in Price and Guest, our task is to ascertain the precise definition of that crime by looking to the scope of the Thirteenth Amendment prohibition of involuntary servitude specified in our prior decisions.

The Thirteenth Amendment declares that "[n]either slavery nor involuntary servitude,

except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction." The Amendment is "self-executing without any ancillary legislation, so far as its terms are applicable to any existing state of circumstances," Civil Rights Cases, 109 U.S. 3, 20, 3 S.Ct. 18, 28, 27 L. Ed. 835 (1883), and thus establishes a constitutional guarantee that is protected by § 241. See Price, supra, 383 U.S., at 805, 86 S.Ct., at 1162-1163. The primary purpose of the Amendment was to abolish the institution of African slavery as it had existed in the United States at the time of the Civil War, but the Amendment was not limited to that purpose; the phrase "involuntary servitude" was intended to extend "to cover those forms of compulsory labor akin to African slavery which in practical operation would tend to produce like undesirable results." Butler v. Perry, 240 U.S. 328, 332, 36 S.Ct. 258, 259, 60 L.Ed. 672 (1916). See also Robertson v. Baldwin, 165 U.S. 275, 282, 17 S.Ct. 326, 329, 41 L.Ed. 715 (1897); Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 69, 21 L.Ed. 394 (1873).

While the general spirit of the phrase "involuntary servitude" is easily comprehended, the exact range of conditions it prohibits is harder to define. The express exception of involuntary servitude imposed as a punishment for crime provides some guidance. The fact that the drafters felt it necessary to exclude this situation indicates that they thought involuntary servitude includes at least situations in which the victim is compelled to work by law. Moreover, from the general intent to prohibit conditions "akin to African slavery," see Butler v. Perry, supra, 240 U.S., at 332-333, 36 S.Ct., at 259, as well as the fact that the Thirteenth Amendment extends beyond state action, compare U.S. Const., Amdt. 14, § 1, we readily can deduce an intent to prohibit compulsion through physical coercion.

This judgment is confirmed when we turn to our previous decisions construing the Thirteenth Amendment. Looking behind the broad statements of purpose to the actual holdings, we find that in every case in which this Court has found a condition of involuntary servitude, the victim had no available choice but to work or be subject to legal sanction. In Clyatt v. United States, 197 U.S. 207, 25 S.Ct. 429, 49 L.Ed. 726 (1905), for example, the Court recognized that peonage--a condition in which the victim is coerced by threat of legal sanction to work off a debt to a master--is involuntary servitude under the Thirteenth Amendment. Id., at 215, 218, 25 S.Ct., at 430, 431. Similarly, in United States v. Reynolds, 235 U.S. 133, 35 S.Ct. 86, 59 L.Ed. 162 (1914), the Court held that "[c]ompulsion of ... service by the constant fear of imprisonment under the criminal laws" violated "rights intended to be secured by the Thirteenth Amendment." Id., at 146, 150, 35 S.Ct., at 89, 90. In that case the Court struck down a criminal surety system under which a person fined for a misdemeanor offense could contract to work for a surety who would, in turn, pay the convict's fine to the State. The critical feature of the system was that that breach of the labor contract by the convict was a crime. The convict was thus forced to

work by threat of criminal sanction. The Court has also invalidated state laws subjecting debtors to prosecution and criminal punishment for failing to perform labor after receiving an advance payment. Pollock v. Williams, 322 U.S. 4, 64 S.Ct. 792, 88 L.Ed. 1095 (1944); Taylor v. Georgia, 315 U.S. 25, 62 S.Ct. 415, 86 L.Ed. 615 (1942); Bailey v. Alabama, 219 U.S. 219, 31 S.Ct. 145, 55 L.Ed. 191 (1911). The laws at issue in these cases made failure to perform services for which money had been obtained prima facie evidence of intent to defraud. The Court reasoned that "the State could not avail itself of the sanction of the criminal law to supply the compulsion [to enforce labor] any more than it could use or authorize the use of physical force." Bailey, supra, at 244, 31 S.Ct., at 152.

Our precedents reveal that not all situations in which labor is compelled by physical coercion or force of law violate the Thirteenth Amendment. By its terms the Amendment excludes involuntary servitude imposed as legal punishment for a crime. Similarly, the Court has recognized that the prohibition against involuntary servitude does not prevent the State or Federal Governments from compelling their citizens, by threat of criminal sanction, to perform certain civic duties. See Hurtado v. United States, 410 U.S. 578, 589, n. 11, 93 S.Ct. 1157, 1164, n. 11, 35 L.Ed.2d 508 (1973) (jury service); Selective Draft Law Cases, 245 U.S. 366, 390, 38 S.Ct. 159, 165, 62 L.Ed. 349 (1918) (military service); Butler v. Perry, supra (roadwork). Moreover, in Robertson v. Baldwin, 165 U.S. 275, 17 S. Ct. 326, 41 L.Ed. 715 (1897), the Court observed that the Thirteenth Amendment was not intended to apply to "exceptional" cases well established in the common law at the time of the Thirteenth Amendment, such as "the right of parents and guardians to the custody of their minor children or wards," id., at 282, 17 S.Ct., at 329, or laws preventing sailors who contracted to work on vessels from deserting their ships. Id., at 288, 17 S.Ct., at 331.

Putting aside such exceptional circumstances, none of which are present in this case, our precedents clearly define a Thirteenth Amendment prohibition of involuntary servitude enforced by the use or threatened use of physical or legal coercion. The guarantee of freedom from involuntary servitude has never been interpreted specifically to prohibit compulsion of labor by other means, such as psychological coercion. We draw no conclusions from this historical survey about the potential scope of the Thirteenth Amendment. Viewing the Amendment, however, through the narrow window that is appropriate in applying § 241, it is clear that the Government cannot prove a conspiracy to violate rights secured by the Thirteenth Amendment without proving that the conspiracy involved the use or threatened use of physical or legal coercion.

B

Section 1584 authorizes criminal punishment of

> "[w]hoever knowingly and willfully holds to involuntary servitude or sells into any condition of involuntary servitude any other person for any term."

This is our first occasion to consider the reach of this statute. The pivotal phrase, "involuntary servitude," clearly was borrowed from the Thirteenth Amendment. Congress' use of the constitutional language in a statute enacted pursuant to its constitutional authority to enforce the Thirteenth Amendment guarantee makes the conclusion that Congress intended the phrase to have the same meaning in both places logical, if not inevitable. In the absence of any contrary indications, we therefore give effect to congressional intent by construing "involuntary servitude" in a way consistent with the understanding of the Thirteenth Amendment that prevailed at the time of § 1584's enactment. See United States v. Shackney, 333 F.2d 475 (CA2 1964) (Friendly, J.).

Section 1584 was enacted as part of the 1948 revision to the Criminal Code. At that time, all of the Court's decisions identifying conditions of involuntary servitude had involved compulsion of services through the use or threatened use of physical or legal coercion. See, e.g., Clyatt v. United States, supra; United States v. Reynolds, supra; Pollock v. Williams, supra; Bailey v. Alabama, supra. By employing the constitutional language, Congress apparently was focusing on the prohibition of comparable conditions.

The legislative history of § 1584 confirms this conclusion and undercuts the Government's claim that Congress had a broader concept of involuntary servitude in mind. No significant legislative history accompanies the 1948 enactment of § 1584; the statute was adopted as part of a general revision of the Criminal Code. The 1948 version of § 1584 was a consolidation, however, of two earlier statutes: the Slave Trade statute, as amended in 1909, formerly 18 U.S.C. § 423 (1940 ed.), and the 1874 Padrone statute, formerly 18 U.S. C. § 446 (1940 ed.). There are some indications that § 1584 was intended to have the same substantive reach as these statutes. See, e.g., A. Holtzoff, Preface to Title 18 U.S.C.A. (1969) ("In general, with a few exceptions, the Code does not attempt to change existing law"); Revision of Titles 18 and 28 of the United States Code: Hearings on H.R. 1600 and H.R. 2055 before Subcommittee No. 1 of the House Committee on the Judiciary, 80th Cong., 1st Sess., 13-14 (1947) (statement of advisory committee member Justin Miller). But see United States v. Shackney, supra, at 482 (viewing changes made in the course of consolidation as significant and § 1584 as positive law). Whether or not § 1584 was intended to track these earlier statutes exactly, it was most assuredly not intended to work a radical change in the law. We therefore review the legislative history of the Slave Trade statute and the Padrone statute to inform our construction of § 1584.

The original Slave Trade statute authorized punishment of persons who "hold, sell, or otherwise dispose of any ... negro, mulatto, or person of colour, so brought [into the United States] as a slave, or to be held to service or labour." Act of Apr. 20, 1818, ch. 91, § 6, 3

Stat. 450, 452. This statute was one of several measures passed in the early 19th century for the purpose of ending the African slave trade. A 1909 amendment removed the racial restriction, extending the statute to the holding of "any person" as a slave. This revision, however, left unchanged that portion of the statute describing the condition under which such persons were held. See 42 Cong.Rec. 1114 (1908). The Government attempts to draw a contrary conclusion from a comment by Senator Heyburn to the effect that the 1909 amendment was intended to protect vulnerable people who were brought into the United States for labor or for immoral purposes. Id., at 1115. This comment is inconclusive, however. Other Senators expressly disagreed with the view that the elimination of the racial restriction changed the meaning of the word "slavery." See id., at 1114-1115. Moreover, the 1909 reenactment of the Slave Trade statute was part of a general codification of the federal penal laws, which Senator Heyburn himself stated was "in no instance to change the practice of the law." Id., at 2226. Thus, we conclude that nothing in the history of the Slave Trade statute suggests that it was intended to extend to conditions of servitude beyond those applied to slaves, i.e., physical or legal coercion.

The other precursor of § 1584, the Padrone statute, reflects a similarly limited scope. The "padrones" were men who took young boys away from their families in Italy, brought them to large cities in the United States, and put them to work as street musicians or beggars. Congress enacted the Padrone statute in 1874 "to prevent [this] practice of enslaving, buying, selling, or using Italian children." 2 Cong.Rec. 4443 (1874) (Rep. Cessna). The statute provided that

> "whoever shall knowingly and wilfully bring into the United States ... any person inveigled or forcibly kidnapped in any other country, with intent to hold such person ... in confinement or to any involuntary service, and whoever shall knowingly and wilfully sell, or cause to be sold, into any condition of involuntary servitude, any other person for any term whatever, and every person who shall knowingly and wilfully hold to involuntary service any person so sold and bought, shall be deemed guilty of a felony." Act of June 23, 1874, ch. 464. 18 Stat. 251.

This statute, too, was aimed only at compulsion of service through physical or legal coercion. To be sure, use of the term "inveigled" indicated that the statute was intended to protect persons brought into this country by other means. But the statute drew a careful distinction between the manner in which persons were brought into the United States and the conditions in which they were subsequently held, which are expressly identified as "confinement" or "involuntary servitude." Our conclusion that Congress believed these terms to be limited to situations involving physical or legal coercion is confirmed when we examine the actual physical conditions facing the victims of the padrone system. These young children were literally stranded in large, hostile cities in a foreign country. They

were given no education or other assistance toward self-sufficiency. Without such assistance, without family, and without other sources of support, these children had no actual means of escaping the padrones' service; they had no choice but to work for their masters or risk physical harm. The padrones took advantage of the special vulnerabilities of their victims, placing them in situations where they were physically unable to leave.

The history of the Padrone statute reflects Congress' view that a victim's age or special vulnerability may be relevant in determining whether a particular type or a certain degree of physical or legal coercion is sufficient to hold that person to involuntary servitude. For example, a child who is told he can go home late at night in the dark through a strange area may be subject to physical coercion that results in his staying, although a competent adult plainly would not be. Similarly, it is possible that threatening an incompetent with institutionalization or an immigrant with deportation could constitute the threat of legal coercion that induces involuntary servitude, even though such a threat made to an adult citizen of normal intelligence would be too implausible to produce involuntary servitude. But the Padrone statute does not support the Court of Appeals' conclusion that involuntary servitude can exist absent the use or threatened use of physical or legal coercion to compel labor. Moreover, far from broadening the definition of involuntary servitude for immigrants, children, or mental incompetents, § 1584 eliminated any special distinction among, or protection of, special classes of victims.

Thus, the language and legislative history of § 1584 both indicate that its reach should be limited to cases involving the compulsion of services by the use or threatened use of physical or legal coercion. Congress chose to use the language of the Thirteenth Amendment in § 1584 and this was the scope of that constitutional provision at the time § 1584 was enacted.

C

The Government has argued that we should adopt a broad construction of "involuntary servitude," which would prohibit the compulsion of services by any means that, from the victim's point of view, either leaves the victim with no tolerable alternative but to serve the defendant or deprives the victim of the power of choice. Under this interpretation, involuntary servitude would include compulsion through psychological coercion as well as almost any other type of speech or conduct intentionally employed to persuade a reluctant person to work.

This interpretation would appear to criminalize a broad range of day-to-day activity. For example, the Government conceded at oral argument that, under its interpretation, § 241 and § 1584 could be used to punish a parent who coerced an adult son or daughter into

working in the family business by threatening withdrawal of affection. Tr. of Oral Arg. 12. It has also been suggested that the Government's construction would cover a political leader who uses charisma to induce others to work without pay or a religious leader who obtains personal services by means of religious indoctrination. See Brief in Opposition 4; Brief for the International Society for Krishna Consciousness of California, Inc., as Amicus Curiae 25. As these hypotheticals suggest, the Government's interpretation would delegate to prosecutors and juries the inherently legislative task of determining what type of coercive activities are so morally reprehensible that they should be punished as crimes. It would also subject individuals to the risk of arbitrary or discriminatory prosecution and conviction.

Moreover, as the Government would interpret the statutes, the type of coercion prohibited would depend entirely upon the victim's state of mind. Under such a view, the statutes would provide almost no objective indication of the conduct or condition they prohibit, and thus would fail to provide fair notice to ordinary people who are required to conform their conduct to the law. The Government argues that any such difficulties are eliminated by a requirement that the defendant harbor a specific intent to hold the victim in involuntary servitude. But in light of the Government's failure to give any objective content to its construction of the phrase "involuntary servitude," this specific intent requirement amounts to little more than an assurance that the defendant sought to do "an unknowable something." Screws v. United States, 325 U.S., at 105, 65 S.Ct., at 1037.

In short, we agree with Judge Friendly's observation that

> "[t]he most ardent believer in civil rights legislation might not think that cause would be advanced by permitting the awful machinery of the criminal law to be brought into play whenever an employee asserts that his will to quit has been subdued by a threat which seriously affects his future welfare but as to which he still has a choice, however painful." United States v. Schackney, 333 F.2d., at 487.

Accordingly, we conclude that Congress did not intend § 1584 to encompass the broad and undefined concept of involuntary servitude urged upon us by the Government.

Justice BRENNAN would hold that § 1584 prohibits not only the use or threatened use of physical or legal coercion, but also any means of coercion "that actually succeeds in reducing the victim to a condition of servitude resembling that in which slaves were held before the Civil War." Post, at 2770. This formulation would be useful if it were accompanied by a recognition that the use or threat of physical or legal coercion was a necessary incident of pre-Civil War slavery and thus of the " 'slave like' conditions of servitude Congress most clearly intended to eradicate." Post, at 2769. Instead, finding no

objective factor to be necessary to a "slave like condition," Justice BRENNAN would delegate to prosecutors and juries the task of determining what working conditions are so oppressive as to amount to involuntary servitude.

Such a definition of involuntary servitude is theoretically narrower than that advocated by the Government, but it suffers from the same flaws. The ambiguity in the phrase "slave like conditions" is not merely a question of degree, but instead concerns the very nature of the conditions prohibited. Although we can be sure that Congress intended to prohibit " 'slave like' conditions of servitude," we have no indication that Congress thought that conditions maintained by means other than by the use or threatened use of physical or legal coercion were "slave like." Whether other conditions are so intolerable that they, too, should be deemed to be involuntary is a value judgment that we think is best left for Congress.

Justice STEVENS concludes that Congress intended to delegate to the Judiciary the inherently legislative task of defining "involuntary servitude" through case-by-case adjudication. Post, at 2772. Neither the language nor the legislative history of § 1584 provides an adequate basis for such a conclusion. Reference to the Sherman Act does not advance Justice STEVENS' argument, for that Act does not authorize courts to develop standards for the imposition of criminal punishment. To the contrary, this Court determined that the objective standard to be used in deciding whether conduct violates the Sherman Act--the rule of reason--was evinced by the language and the legislative history of the Act. Standard Oil Co. v. United States, 221 U.S. 1, 60, 31 S.Ct. 502, 515-516, 55 L. Ed. 619 (1911). It is one thing to recognize that some degree of uncertainty exists whenever judges and juries are called upon to apply substantive standards established by Congress; it would be quite another thing to tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis.

Sound principles of statutory construction lead us to reject the amorphous definitions of involuntary servitude proposed by the Government and by Justices BRENNAN and STEVENS. By construing § 241 and § 1584 to prohibit only compulsion of services through physical or legal coercion, we adhere to the time-honored interpretive guideline that uncertainty concerning the ambit of criminal statutes should be resolved in favor of lenity. See, e.g., McNally v. United States, 483 U.S. 350, 107 S.Ct. 2875, 97 L.Ed.2d 292 (1987); Dowling v. United States, 473 U.S. 207, 229, 105 S.Ct. 3127, 3139, 87 L.Ed.2d 152 (1985); Liparota v. United States, 471 U.S. 419, 427, 105 S.Ct. 2084, 2089, 85 L. Ed.2d 434 (1985); Rewis v. United States, 401 U.S. 808, 812, 91 S.Ct. 1056, 1059, 28 L. Ed.2d 493 (1971). The purposes underlying the rule of lenity--to promote fair notice to those subject to the criminal laws, to minimize the risk of selective or arbitrary

enforcement, and to maintain the proper balance between Congress, prosecutors, and courts--are certainly served by its application in this case.

III

Absent change by Congress, we hold that, for purposes of criminal prosecution under § 241 or § 1584, the term "involuntary servitude" necessarily means a condition of servitude in which the victim is forced to work for the defendant by the use or threat of physical restraint or physical injury, or by the use or threat of coercion through law or the legal process. This definition encompasses those cases in which the defendant holds the victim in servitude by placing the victim in fear of such physical restraint or injury or legal coercion. Our holding does not imply that evidence of other means of coercion, or of poor working conditions, or of the victim's special vulnerabilities is irrelevant in a prosecution under these statutes. As we have indicated, the vulnerabilities of the victim are relevant in determining whether the physical or legal coercion or threats thereof could plausibly have compelled the victim to serve. In addition, a trial court could properly find that evidence of other means of coercion or of extremely poor working conditions is relevant to corroborate disputed evidence regarding the use or threatened use of physical or legal coercion, the defendant's intention in using such means, or the causal effect of such conduct. We hold only that the jury must be instructed that compulsion of services by the use or threatened use of physical or legal coercion is a necessary incident of a condition of involuntary servitude.

The District Court's instruction on involuntary servitude, which encompassed other means of coercion, may have caused the Kozminskis to be convicted for conduct that does not violate either statute. Accordingly, we agree with the Court of Appeals that the convictions must be reversed and the case remanded for a new trial.

We disagree with the Court of Appeals to the extent it determined that a defendant could violate § 241 or § 1584 by means other than the use or threatened use of physical or legal coercion where the victim is a minor, an immigrant, or one who is mentally incompetent. But because we believe the record contains sufficient evidence of physical or legal coercion to enable a jury to convict the Kozminskis even under the stricter standard of involuntary servitude that we announce today, we agree with the Court of Appeals that a judgment of acquittal is unwarranted.

The judgment of the Court of Appeals is affirmed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Justice BRENNAN, with whom Justice MARSHALL joins, concurring in the judgment.

I agree with the Court that the construction given 18 U.S.C. § 1584 by the District Court and the Government either sweeps beyond the intent of Congress or fails to define the criminal conduct with sufficient specificity, and that a new trial under different instructions is therefore required. I cannot, however, square the Court's decision to add a physical or legal coercion limitation to the statute with either the statutory text or legislative history, and would adopt a different statutory construction that, I think, defines the crime with sufficient specificity but comports better with the evident intent of Congress.

I

It is common ground among the parties and all the courts and Justices that have interpreted § 1584 (FN1) that it encompasses, at a minimum, the compulsion of labor via the use or threat of physical or legal coercion. That much need not be belabored, for the use of the master's whip and the power of the State to compel one human to labor for another were clearly core elements of slavery that the Thirteenth Amendment and its statutory progeny intended to eliminate. As the Government points out, however, the language of both the Thirteenth Amendment and § 1584 simply prohibits "involuntary servitude" and contains no words limiting the prohibition to servitude compelled by particular methods. "[The Thirteenth] amendment denounces a status or condition, irrespective of the manner or authority by which it is created." Clyatt v. United States, 197 U.S. 207, 216, 25 S.Ct. 429, 430, 49 L.Ed. 726 (1905).

If as a factual matter the use or threat of physical or legal coercion were the only methods by which a condition of involuntary servitude could be created, then the constitutional and statutory text might provide some support for the Court's conclusion. But the Court does not dispute that other methods can coerce involuntary labor--indeed it is precisely the broad range of nonphysical private activities capable of coercing labor that the Court cites as the basis for its vagueness concerns. See ante, at 2763; see also n. 5, infra. I address those concerns below, but the point here is only that those concerns, however serious, are not textual concerns, for the text suggests no grounds for distinguishing among different means of coercing involuntary servitude. Nor do I know of any empirical grounds for assuming that involuntary servitude can be coerced only by physical or legal means. (FN2) To the contrary, it would seem that certain psychological, economic, and social means of coercion can be just as effective as physical or legal means, particularly where the victims are especially vulnerable, such as the mentally disabled victims in this case. Surely threats to burn down a person's home or business or to rape or kill a person's spouse or children can have greater coercive impact than the mere threat of a beating, yet the coercive impact of such threats turns not on any direct physical effect that would be felt by

the laborer but on the psychological, emotional, social, or economic injury the laborer would suffer as a result of harm to his or her home, business, or loved ones. And drug addiction or the weakness resulting from a lack of food, sleep, or medical care can eliminate the will to resist as readily as the fear of a physical blow. Hypnosis, blackmail, fraud, deceit, and isolation are also illustrative methods--but it is unnecessary here to canvas the entire spectrum of nonphysical machinations by which humans coerce each other. It suffices to observe that one can imagine many situations in which nonphysical means of private coercion can subjugate the will of a servant.

Indeed, this case and others readily reveal that the typical techniques now used to hold persons in slave like conditions are not limited to physical or legal means. The techniques in this case, for example, included disorienting the victims with frequent verbal abuse and complete authoritarian domination; inducing poor health by denying medical care and subjecting the victims to substandard food, clothing, and living conditions; working the victims from 3 a.m. to 8:30 p.m. with no days off, leaving them tired and without free time to seek alternative work; denying the victims any payment for their labor; and active efforts to isolate the victims from contact with outsiders who might help them. (FN3) Without considering these techniques (and their particular effect on a mentally disabled person), one would hardly have a complete picture of whether the coercion inflicted on the victims was sufficient to make their servitude involuntary. Other involuntary servitude cases have also chronicled a variety of nonphysical and nonlegal means of coercion including trickery; isolation from friends, family, transportation or other sources of food, shelter, clothing, or jobs; denying pay or creating debt that is greater than the worker's income by charging exorbitant rates for food, shelter, or clothing; disorienting the victims by placing them in an unfamiliar environment, barraging them with orders, and controlling every detail of their lives; and weakening the victims with drugs, alcohol, or by lack of food, sleep, or proper medical care. See, e.g., United States v. Warren, 772 F.2d 827 (CA11 1985); United States v. Mussry, 726 F.2d 1448 (CA9 1984); United States v. Ingalls, 73 F.Supp. 76 (SD Cal.1947). One presumes these methods of coercion would not reappear with such depressing regularity if they were ineffective. (FN4)

My reading of the statutory language as not limited to physical or legal coercion is strongly bolstered by the legislative history. Section 1584 was created out of the consolidation of the Slave Trade statute and the Padrone statute. Ante, at 2761. I agree with the Government that the background of both those statutes suggests that Congress intended to protect persons subjected to involuntary servitude by forms of coercion more subtle than force. The Padrone statute, for example, was designed to outlaw what was known as the "padrone system" whereby padrones in Italy inveigled from their parents young boys whom the padrones then used without pay as beggars, bootblacks, or street musicians. Once in this country, without relatives to turn to, the children had little choice

but to submit to the demands of those asserting authority over them, yet this form of coercion was deemed sufficient--without any evidence of physical or legal coercion--to hold the boys in "involuntary servitude." See United States v. Ancarola, 1 F. 676, 682-684 (CC SDNY 1880). Given the nature of the system the Padrone statute aimed to eliminate, the statute's use of the words "involuntary servitude" demonstrates not that the statute was "aimed only at compulsion of service through physical or legal coercion," ante, at 2762, but that Congress understood "involuntary servitude" to cover servitude compelled through other means of coercion. (FN5) Indeed, the official title of the Padrone statute was "An act to protect persons of foreign birth against forcible constraint or involuntary servitude," Act of June 23, 1874, ch. 464, 18 Stat. 251 (emphasis added); 2 Cong.Rec. 4443 (1874), and the legislative history describes the statute as broadly "intended to prevent the practice of enslaving, buying, selling, or using Italian children," ibid. (Rep.Cessna) (emphasis added). (FN6)

In light of this legislative history, the Court of Appeals below concluded that § 1584 must at least be construed to criminalize nonphysical means of private coercion used to obtain the services of particularly vulnerable victims such as minors, immigrants, or the mentally disabled. 821 F.2d 1186, 1190-1192 (CA6 1987). I agree with the Court, however, that this creation of specially protected classes of victims is both textually unsupported and inconsistent with Congress' decision to eliminate such distinctions in enacting § 1584, ante, at 2763, and thus turn to the task of defining what I regard as the proper construction of the statute.

II

Based on an analysis of the statutory language and legislative history similar to that set forth in Part I, the Government concludes that § 1584 criminalizes any conduct that intentionally coerces involuntary service. It is of course not easy to articulate when a person's actions are "involuntary." In some minimalist sense the laborer always has a choice no matter what the threat: the laborer can choose to work, or take a beating; work, or go to jail. We can all agree that these choices are so illegitimate that any decision to work is "involuntary." But other coercive choices, even if physical or legal in nature, might present closer questions. Happily, our task is not to resolve the philosophical meaning of free will, but to determine what coercion Congress would have regarded as sufficient to deem any resulting labor "involuntary" within the meaning of § 1584.

The Government concludes that the statute encompasses any coercion that either leaves the victim with "no tolerable alternative" but to serve the defendant or deprives the victim of "the capacity for rational calculation." Brief for United States 19, 33. As the Court notes, however, such a statutory construction potentially sweeps in a broad range of

conduct that Congress could not have intended to criminalize. Ante, at 2763-2764. The Government attempts to avoid many of these problems by stressing that a victim does not lack "tolerable alternatives" when he simply has "no attractive or painless options"; the alternatives must be as bad for the victim as physical injury. Brief for United States 33. One can, however, imagine troublesome applications of that test, such as the employer who coerces an employee to remain at her job by threatening her with bad recommendations if she leaves, the religious leader who admonishes his adherents that unless they work for the church they will rot in hell, or the husband who relegates his wife to years of housework by threatening to seek custody of the children if she leaves. Surely being unable to work in one's chosen field, suffering eternal damnation, or losing one's children can be far worse than taking a beating, but are all these instances of involuntary servitude? The difficulty with the Government's test is that although nonphysical forms of private coercion can indeed be as traumatic as physical force, their coercive impact is more highly individualized than that of physical and legal threats. I thus agree with the Court that criminal punishment cannot turn on a case-by-case assessment of whether the alternatives confronting an individual are sufficiently intolerable to render any continued service "involuntary." Such an approach either renders the test hopelessly subjective (if it relies on the victim's assessment of what is tolerable) or delegates open-ended authority to prosecutors and juries (if it relies on what a reasonable person would consider intolerable). (FN7) Similarly, I agree with the Court that the difficulty of distinguishing the victim deprived of "the capacity for rational calculation" from the victim influenced by love, charisma, persuasive argument, or religious fervor is sufficiently great that the standard fails to define the criminal conduct with sufficient specificity.

The solution, however, lies not in ignoring those forms of coercion that are perhaps less universal in their effect than physical or legal coercion, but in focusing on the "slave like" conditions of servitude Congress most clearly intended to eradicate. That the statute prohibits "involuntary servitude" rather than "involuntary service" provides no small insight into the central evil the statute unambiguously aimed to eliminate. (FN8) For "servitude" generally denotes a relation of complete domination and lack of personal liberty resembling the conditions in which slaves were held prior to the Civil War. Thus, in 1910 and 1949, Webster's defined "servitude" as the "[c]ondition of a slave; slavery; serfdom; bondage; state of compulsory subjection to a master.... In French and English Colonies of the 17th and 18th centuries, the condition of transported or colonial laborers who, under contract or by custom, rendered service with temporary and limited loss of political and personal liberty." Webster's New International Dictionary of the English Language. And in 1913 and 1944 Funk and Wagnalls defined "servitude" as "[t]he condition of a slave; a state of subjection to a master or to arbitrary power of any kind" and cited the same colonial practice. Funk and Wagnalls, New Standard Dictionary of the English Language. (FN9) Our cases have expressed the same understanding. "The word

servitude is of larger meaning than slavery, as the latter is popularly understood in this country, and the obvious purpose was to forbid all shades and conditions of African slavery." Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 69, 21 L.Ed. 394 (1873). "[T]he term involuntary servitude was intended to cover those forms of compulsory labor akin to African slavery which in practical operation would tend to produce like undesirable results." Butler v. Perry, 240 U.S. 328, 332, 36 S.Ct. 258, 259, 60 L.Ed. 672 (1916). See also Bailey v. Alabama, 219 U.S. 219, 241, 31 S.Ct. 145, 151, 55 L.Ed. 191 (1911); Hodges v. United States, 203 U.S. 1, 17, 27 S.Ct. 6, 8-9, 51 L.Ed. 65 (1906).

I thus conclude that whatever irresolvable ambiguity there may be in determining (for forms of coercion less universal than physical or legal coercion) the degree of coercion Congress would have regarded as sufficient to render any resulting labor "involuntary" within the meaning of § 1584, Congress clearly intended to encompass coercion of any form that actually succeeds in reducing the victim to a condition of servitude resembling that in which slaves were held before the Civil War. (FN10) While no one factor is dispositive, complete domination over all aspects of the victim's life, oppressive working and living conditions, and lack of pay or personal freedom are the hallmarks of that slave like condition of servitude. Focusing on such a slave like condition not only accords with the type of servitude Congress unambiguously intended to eliminate but also comports well with the policies behind the statute, for the concern that coerced laborers will be unable to relieve themselves from harsh work conditions by changing employers is less likely to be implicated if that laborer has a normal job with time off, personal freedom, and some money, and has contact with other people. (FN11)

This focus on the actual conditions of servitude also provides an objective benchmark by which to judge either the "intolerability" of alternatives or the victim's capacity for "rational" thought: the alternatives can justifiably be deemed intolerable, or the victim can justifiably be deemed incapable of thinking rationally, if the victim actually felt compelled to live in a slave like condition of servitude. True, in marginal cases it may well be difficult to determine whether a slave like condition of servitude existed, but the ambiguity will be a matter of degree on a factual spectrum, (FN12) not, as in the "no tolerable alternative" or "improper or wrongful conduct" tests, a matter of value on which one would expect wide variation among different prosecutors or jurors. The risk of selective or arbitrary enforcement is thus minimized, and the defendant who, as a result of intentional coercion, employs persons in conditions resembling slavery has fair notice regarding the applicability of the criminal laws. And many of the more troublesome applications of the Government's open-ended test would be avoided. For example, § 1584 would not encompass a claim that a regime of religious indoctrination psychologically coerced adherents to work for the church unless it could also be shown that the adherents worked in a slave like condition of servitude and (given the intent requirement) that the religious

indoctrination was not motivated by a desire to spread sincerely held religious beliefs but rather by the intent to coerce adherents to labor in a slave-like condition of servitude.

This restrictive construction of limiting the statute to slave like conditions, although necessary to comply with the rule of lenity given the inherent ambiguity of the statute where the coercion is neither physical nor legal, is not, however, necessary where the defendant compels involuntary service by the use or threat of legal or physical means. Because the coercive impact of legal or physical coercion is less individualized than other forms of coercion, we need be less concerned about selective or arbitrary enforcement; and the defendant who intentionally employs physical or legal means to coerce labor has fair notice his acts may be criminal. The ambiguity justifying a restrictive reading is, moreover, not present when the means of coercion are those at the heart of the institution of slavery, and it seems clear that Congress would have regarded a victim working under a legal or physical threat as serving in a condition of servitude, however limited in time or scope. (FN13)

III

In sum, I conclude that § 1584 reaches cases where the defendant intentionally coerced the victim's labor by the use or threat of legal or physical means or the defendant intentionally coerced the victim into a slave like condition of servitude by other forms of coercion or by rendering the defendant incapable of rational choice. I therefore concur in the judgment.

Justice STEVENS, with whom Justice BLACKMUN joins, concurring in the judgment.

No matter what we write, this case must be remanded for a new trial because the Court of Appeals held that expert testimony was erroneously admitted and the Government has not asked us to review that holding. My colleagues' opinions attempting to formulate an all-encompassing definition of the term "involuntary servitude" demonstrate that this legislative task is not an easy one. They also persuade me that Congress probably intended the definition to be developed in the common-law tradition of case-by-case adjudication, much as the term "restraint of trade" has been construed in an equally vague criminal statute.

In rejecting an argument that the Sherman Act was unconstitutionally vague, Justice Holmes wrote:

> "But apart from the common law as to restraint of trade thus taken up by the statute the law is full of instances where a man's fate depends on his estimating rightly, that is, as the jury subsequently estimates it, some matter of degree. If

> his judgment is wrong, not only may he incur a fine or a short imprisonment, as here; he may incur the penalty of death. 'An act causing death may be murder, manslaughter, or misadventure according to the degree of danger attending it' by common experience in the circumstances known to the actor. 'The very meaning of the fiction of implied malice in such cases at common law was, that a man might have to answer with his life for consequences which he neither intended nor foresaw.' Commonwealth v. Pierce, 138 Massachusetts, 165, 178 [(1884)]. Commonwealth v. Chance, 174 Massachusetts, 245, 252 [54 N.E. 551 (1899)]. 'The criterion in such cases is to examine whether common social duty would, under the circumstances, have suggested a more circumspect conduct.' [1 E. East, Pleas of the Crown 262 (1803)]." Nash v. United States, 229 U.S. 373, 377, 33 S.Ct. 780, 781, 57 L.Ed. 1232 (1913).

A similar approach to the statute before us in this case was expressed by Judge Guy in his dissenting opinion in the Court of Appeals:

> "It is clear that 18 U.S.C. § 1584 is lacking in definitional precision when it makes criminal the holding of one in 'involuntary servitude.' Whether this is the genius of this section or a deficiency to be cured by judicial legislation is not so clear. The majority apparently concludes it is a deficiency and proceeds to cure it by substituting an arbitrary definition that raises more questions than it answers. In discussing this specific section, Judge Dimock, who concurred in Shackney, prophetically wrote:
>
> " 'To have an arbitrary classification which will resolve with equal facility all of the cases that would arise under the statute is indeed a tempting prospect. It is much harder to have to work under a statute which will raise difficult questions in the borderline cases inevitable whenever the application of a statute depends upon an appraisal of the state of the human mind. 333 F.2d at 488.'

.....

* * *

"This is not an easy definitional question and it is one on which reasonable minds and federal circuits might differ. I write in dissent, however, primarily because I believe the majority has rewritten rather than interpreted 18 U.S.C. § 1584." 821 F.2d 1186, 1212-1213 (CA6 1987).

I have a similar reaction to both Justice O'CONNOR's opinion for the Court and to Justice BRENNAN's concurrence. They are both unduly concerned with hypothetical cases that

are not before the Court and that, indeed, are far removed from the facts of this case. Although these hypothetical cases present interesting and potentially difficult philosophical puzzles, I doubt that they have any significant relationship to real world decisions that will be faced by possible defendants, prosecutors, or jurors. (FN1)

The text of § 1584 identifies three components of this criminal offense. (FN2) First, the defendant must have acted "knowingly and willfully." As the District Court instructed the jury, the Government has the burden of proving that the defendants had "the specific intent" to commit the offense. (FN3) Infra, at 2776-2777. Second, they must have imposed an "involuntary" condition upon their victims. As the District Court correctly stated, the term "involuntary" means " 'done contrary to or without choice'--'compulsory'--'not subject to control of the will.' " Infra, at 2775. Third, the condition that must have been deliberately imposed on the victims against their will must have been a condition of "servitude." As the District Court explained, the term "servitude" means " '[a] condition in which a person lacks liberty especially to determine one's course of action or way of life'--'slavery'--'the state of being subject to a master.' " (FN4) Ibid. The judge further instructed the jury that the defendants could not be found guilty unless they had used "a means of compulsion ... sufficient in kind and degree, to subject a person having the same general station in life as the alleged victims to believe they had no reasonable means of escape and no choice except to remain in the service of the employer." Infra, at 2775.

I agree with Justice BRENNAN that the reach of the statute extends beyond compulsion that is accompanied by actual or threatened physical means or by the threat of legal action. See ante, at 2765-2768. The statute applies equally to "physical or mental restraint," cf. Chatwin v. United States, 326 U.S. 455, 460, 66 S.Ct. 233, 235, 90 L.Ed. 198 (1946), and I would not distinguish between the two kinds of compulsion. However, unlike Justice BRENNAN, I would not impose the additional requirement in cases involving mental restraint that the victim be coerced into a "slave like condition of servitude." To the extent the phrase "slave like condition of servitude" simply mirrors the term "involuntary servitude," I see no reason for imposing this additional level of definitional complexity. In my view, individuals attempting to conform their conduct to the rule of law, prosecutors, and jurors are just as capable of understanding and applying the term "involuntary servitude" as they are of applying the concept of "slave like condition." Moreover, to the extent "slave like condition of servitude" means something less than "involuntary servitude," I see no basis for reading the statute more narrowly than written. Instead, in determining whether the victims' servitude was "involuntary," I would allow the jury to consider the "totality of the circumstances" just as we do when it is necessary to decide whether a custodial statement is voluntary or involuntary, see, e.g., Mincey v. Arizona, 437 U.S. 385, 401, 98 S.Ct. 2408, 2418, 57 L.Ed.2d 290 (1978). In this case, however, the

burden is of course on the Government to prove that the victims did not accept the terms of their existence voluntarily.

In sum, taking the evidence in the light most favorable to the Government, see Glasser v. United States, 315 U.S. 60, 80, 62 S.Ct. 457, 469, 86 L.Ed. 680 (1942), I am persuaded that the statute gave the defendants fair notice that their conduct was unlawful and that the trial court's instructions, read as a whole, adequately informed the jury as to the elements of the crime. I think they were fairly convicted.

Nevertheless, as I stated at the outset, I must concur in the Court's judgment.

APPENDIX

RELEVANT JURY INSTRUCTIONS

(App. to Pet. for Cert. 108a-114a.)

"[Court:] In order to find a particular defendant guilty as charged in Counts II and III of the Indictment, the government must prove beyond a reasonable doubt each of the following elements as to Robert Fulmer for Count II and as to Louis Molitoris for Count III:

"1. That a particular defendant held or aided and abetted in the holding of Robert Fulmer under Count II or Louis Molitoris under Count III to involuntary servitude for a term.

"2. That the act or acts of the defendants were done knowingly or willfully.

"If you find that the government has proved the above two elements as to a particular defendant and as to a particular count beyond a reasonable doubt, then your verdict will be guilty as to that count and that defendant.

"If, however, you find that the government has failed to prove either or both of the elements set forth above as to a particular defendant and as to a particular count, then your verdict will be not guilty as to that defendant and that count.

"As stated before, the burden is always upon the prosecution to prove beyond a reasonable doubt every element essential to the crime charged; the law never imposes upon the defendant in a criminal case the burden or duty of calling any witnesses or of producing any evidence.

"A person who willfully aids and abets another in the commission of an offense is punishable as a principal.

"In order to aid and abet another to commit a crime it is necessary that the accused willfully associate himself in some way with the criminal venture, and willfully participate in it as in something he wishes to bring about; that is to say, that he willfully seeks by some act or omission to make the criminal venture succeed.

"You, of course, may not find a defendant guilty as to a particular count unless you find beyond a reasonable doubt that every element of the particular offense as defined in these instructions was committed by some person or persons, and that that defendant participated in its commission.

"The government is not required to prove that a defendant personally committed the offense charged. Rather, the government bears the burden of showing (1) that every element of a particular offense as defined in these instructions was committed by some person or persons and (2) that a defendant (a) was that person or one of those persons, or (b) aided and abetted that person or those persons in the commission of the offense.

"Involuntary servitude consists of two terms.

"Involuntary means 'done contrary to or without choice'--'compulsory'--'not subject to control of the will.'

"Servitude means '[a] condition in which a person lacks liberty especially to determine one's course of action or way of life'--'slavery'--'the state of being subject to a master.'

"Involuntary servitude involves a condition of having some of the incidents of slavery.

"It may include situations in which persons are forced to return to employment by law.

"It may also include persons who are physically restrained by guards from leaving employment.

"It may also include situations involving either physical and other coercion, or a combination thereof, used to detain persons in employment.

"It may include situations in which the coercive acts or words cause persons in employment to believe they cannot freely leave employment if the acts are done or the words spoken with the intent to cause this result.

"In other words, based on all the evidence it will be for you to determine if there was a means of compulsion used, sufficient in kind and degree, to subject a person having the same general station in life as the alleged victims to believe they had no reasonable means of escape and no choice except to remain in the service of the employer. In this respect you are instructed that you may find that not all persons are of like courage and firmness. You may consider the character and condition of life of the parties, the relative inferiority or inequality between the persons who perform the service and the persons exercising the force or influence to compel its performance and the defendants' knowledge of these matters.

"The matter involves the knowledge and intent of the person charged as well as the character and understanding of the alleged victim.

"It is not part of the Government's burden of proof, in order for you to return a verdict of guilty, to show that an alleged victim named in the Indictment made an attempt to escape. You may, however, consider any evidence of escape attempts as well as the opportunities to leave and the voluntary remaining or returning as bearing upon the voluntariness of the person's labor.

"In determining whether the service was involuntary, you are instructed that it makes no difference whether or not the persons alleged to have been held in involuntary servitude initially agreed voluntarily to work. If a person desires to withdraw, and then is forced to remain and perform services against his will, his service is involuntary.

"In the same sense, the failure to pay a person who voluntarily performs labor does not transform that labor into an 'involuntary servitude.'

"Of course, an employer can use any legitimate means to retain the services of an employee, such as offering the employee benefits, or seeking to convince the employee that he would be better off if he continued in his employment.

"Payment of wages to the alleged victims or the conferring of other benefits on them is of course a proper means of attempting to retain their services. You should take evidence of such payment or benefits into account in your determination of whether or not the improper conduct of a particular defendant, if you find such improper conduct to have occurred, was a necessary cause of the decision of one or both of the alleged victims to remain on the farm. However, the fact that the alleged victims were paid or were given other benefits does not necessarily mean that they were not held in involuntary servitude.

"As I have instructed you, you must consider all of the factors that might have influenced the decision of both of the alleged victims to remain on the farm. The desire to receive wages and benefits may have been one such factor. However, you must still determine whether or not the improper conduct of a defendant, if any, was a necessary cause of the decision of one or both of the alleged victims to remain.

"In order to find that a particular defendant is guilty of holding one or both of the alleged victims in involuntary servitude, in addition to the necessary coercion and intention on the part of the defendants, you must find that those means were an actual and necessary cause of the decision of one or both of the alleged victims to continue working for the Kozminskis. In other words, you must determine if one or both of the alleged victims would have left the employment if they had not been subjected to improper conduct on the part of that particular defendant.

"In determining whether or not the improper means was a necessary cause of the decision of the alleged victim to continue working for the Kozminskis, you must evaluate all of the factors that might have affected that decision, including any legitimate means used by that defendant to convince the alleged victim to retain the employment. After considering all of the factors that might have affected that decision, you must decide whether or not the decision of either or both of the alleged victims to remain on the farm would have been made if improper means had not been used by a particular defendant.

"If you determine that either or both of the alleged victims would have continued to work for the Kozminskis regardless of the use of improper means by that particular defendant then you must find that the improper conduct of that defendant was not a necessary cause of the decision of both victims to retain their employment.

"In making the determination involving involuntary servitude, you may consider all of the evidence in this case to determine if a particular defendant held or aided and abetted in the holding of either Louis Molitoris or Robert Arthur Fulmer to involuntary servitude.

"I caution you again as I have before, however, the defendants are not on trial for failure to comply with minimum wage laws, or for violating certain social regulations or for assault or battery or for using bad language in a coercive way. Neither are they on trial for neglect, for misappropriation of money, or for breach of an employment contract. Your attention must be directed to the discrete charge outlined in these instructions.

"You will note that Element One requires proof that the victim was held 'for a term,' that is, a period of time. In that respect, I instruct you that it is not necessary for the Government to prove any given specific term of an appreciable length of time. If the

person was held for any term, regardless of how short such term may be, it would come within the 'held for a term' provisions of the statute.

"Element Two requires that the acts of the defendants were done knowingly and willfully.

"An act, omission, or failure to act is done 'knowingly' if done voluntarily and intentionally, and not because of mistake or accident or other innocent reason.

"The word 'knowingly' is used to insure that no one will be convicted for an act done because of mistake, or accident, or other innocent reason.

"An act, omission, or failure to act is done 'willfully' if done voluntarily and intentionally, and with the specific intent to do something the law forbids; that is to say, with bad purpose either to disobey or to disregard the law.

"You will note that to act knowingly requires that the act be done intentionally. The crimes charged requires proof of specific intent before a defendant can be convicted. Specific intent, as the term implies, means more than the general intent to commit the act. To establish specific intent the government must prove that the defendant knowingly did an act which the law forbids, or knowingly failed to do an act which the law requires, purposely intending to violate the law.

"Such intent may be determined from all the facts and circumstances surrounding the case. Specific intent must be proved beyond a reasonable doubt before there can be a conviction.

"Intent ordinarily may not be proved directly, because there is no way of fathoming or scrutinizing the operations of the human mind. But, you may infer the defendant's intent from the surrounding circumstances.

"You may consider any statement made by the defendant, and all other facts and circumstances in evidence which indicate the state of mind. You may consider it reasonable to draw the inference and find that a person intends the natural and probable consequences of acts knowingly done or knowingly omitted.

"As I have said, it is entirely up to you to decide what facts to find from the evidence.

"You will note that the Indictment charges that the offense was committed 'on or about' a certain date. The proof need not establish with certainty the exact date of the alleged offense. It is sufficient if the evidence in the case establishes, beyond a reasonable doubt,

that the offense was committed on a date reasonably near the date alleged.

"That is the end of the instructions relating to Counts II and III of the Indictment."

Footnotes:

(FN*) The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See United States v. Detroit Lumber Co., 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

(FN1.) Title 18 U.S.C. § 2 provides, in pertinent part, that "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

(FN2.) The Government produced an expert witness who testified that the Kozminskis' general treatment of the two men caused the men to undergo an "involuntary conversion" to complete dependency. App. to Pet. for Cert. 15a. The Court of Appeals held that this expert testimony was admitted in violation of Federal Rule of Evidence 702. The Government has not sought review of this ruling, and we do not address it.

(FN1.) The District Court instructed the jury to incorporate the definition of "involuntary servitude" from § 1584 into 18 U.S.C. § 241. The parties did not challenge this incorporation either below or in this Court, but rather argued only that the § 1584 definition the District Court incorporated was incorrect. 821 F.2d 1186, 1188, n. 3 (CA6 1987). I therefore believe it appropriate to address only the proper construction of § 1584. I note also that the § 241 count of the indictment charged a conspiracy to interfere with the "free exercise and enjoyment of the right and privilege secured to [the victims] by the Constitution and laws of the United States to be free from involuntary servitude as provided by the Thirteenth Amendment of the United States Constitution." App. 177 (emphasis added). Thus, the parties may have assumed that § 1584 is a "la[w] of the United States" specifying the content of the constitutional right to be free from involuntary servitude, cf. ante, at 2759, and that accordingly if respondents' actions violated § 1584, the conspiracy to engage in those actions would necessarily constitute a violation of § 241. Such an assumption does not strike me as at all unreasonable. At any rate, for whatever reason the parties never raised the argument that the definition of "involuntary servitude" under § 241 should differ from that under § 1584, and I think it imprudent to decide that issue in the first instance in this Court and without briefing.

(FN2.) In other contexts, we have recognized that nonphysical coercion can induce involuntary action. For example, we have interpreted the federal crime of kidnaping to

include the imposition of "an unlawful physical or mental restraint" to confine the victim against his will. Chatwin v. United States, 326 U.S. 455, 460, 66 S.Ct. 233, 235, 90 L.Ed. 198 (1946) (emphasis added). Similarly, in determining when confessions are involuntary, we have noted "coercion can be mental as well physical.... [T]he efficiency of the rack and the thumbscrew can be matched, given the proper subject, by more sophisticated modes of 'persuasion.' " Blackburn v. Alabama, 361 U.S. 199, 206, 80 S.Ct. 274, 279, 4 L.Ed.2d 242 (1960). "When a suspect speaks because he is overborne, it is immaterial whether he has been subjected to a physical or a mental ordeal." Watts v. Indiana, 338 U.S. 49, 53, 69 S.Ct. 1347, 1350, 93 L.Ed. 1801 (1949) (plurality opinion of Frankfurter, J.).

(FN3.) Although not detailed by the Court, the Government introduced evidence that the Kozminskis (1) ripped a phone off the wall in the barn when one of the victims was caught using it, and did not simply "discourage" contact with relatives but falsely told relatives who asked to speak to the victims that the victims did not want to see them and falsely told the victims that their relatives were not interested in them; (2) falsely told neighbors that the victims were in their custody as wards of the State; and (3) refused to allow the victims to seek medical care, even when one was gored by a bull and the tip of the other's thumb was cut off (both victims eventually became very ill while serving the Kozminskis). The Court also neglects to mention that the Government has conceded that the victims were not forcibly held to work on the farm. 821 F.2d, at 1188.

(FN4.) Because the Court today adopts an expansive but rather obscure understanding of what "physical" coercion encompasses, see nn. 5, 12, infra, it is difficult to tell which, if any, of the means of coercion described in the last two paragraphs the Court would deem "physical."

(FN5.) The Court attempts to evade the inconsistency between its interpretation of § 1584 and the coercion covered by the Padrone statute by asserting that the child victims of the padrone system were in a "situatio[n] involving physical ... coercion." Ante, at 2762. Yet the coercion involved, even as the Court describes it, was obviously psychological, social, and economic in nature: "These young children were literally stranded in large, hostile cities in a foreign country. They were given no education or other assistance toward self-sufficiency." Ibid. Although it is heartening that the Court recognizes that strange environs and the lack of money, maturity, education, or family support can establish the coercion necessary for involuntary servitude, labeling such coercion "physical" is at best strained and (other than making the legislative history fit the Court's statutory interpretation) accomplishes little but the elimination of whatever certainty the "physical or legal coercion" test would otherwise provide. See n. 12, infra.

(FN6.) The legislative history of the Slave Trade statute is less conclusive, but in

explaining the necessity of reenacting this ban on importing slaves despite the abolition of slavery and without the statute's original limitation to blacks, Senator Heyburn did make clear that the new statute was intended to protect those who come here "without being a party to the disposition of their services or the control of their rights, whether they be children of irresponsible years and conditions or whether they be people who, because of their environment or the condition of their lives, cannot protect themselves." 42 Cong.Rec. 1115 (1908).

(FN7.) These problems are not solved by limiting the Government's test to "improper or wrongful conduct that is intended to cause, and does cause, the other person to believe that he or she has no alternative but to perform the labor," United States v. Mussry, 726 F.2d 1448, 1453 (CA9 1984) (emphasis added), for the criminal has no way of knowing what conduct the prosecutor or jury will deem sufficiently improper or wrongful to criminalize.

(FN8.) Because, as a criminal statute, § 1584 must be interpreted to conform with special doctrines concerning notice, vagueness, and the rule of lenity, the issue here focuses on what central evil the words "involuntary servitude" unambiguously encompass in a way that can be defined with specificity. The interpretation of "involuntary servitude" here is thus necessarily narrower than it would be if the issue were what enforceable civil rights the Thirteenth Amendment provides of its own force or if the issue here concerned the scope of Congress' Thirteenth Amendment authority to pass laws for abolishing all badges or incidents of slavery or servitude. See Jones v. Alfred H. Mayer Co., 392 U.S. 409, 437-444, 88 S.Ct. 2186, 2202-2206, 20 L.Ed.2d 1189 (1968).

(FN9.) See also 9 Oxford English Dictionary 522 (1933) ("The condition of being a slave or serf, or of being the property of another person; absence of personal freedom. Often, and now usually, with the added notion of subjection to the necessity of excessive labor"); Webster's American Dictionary of the English Language 1207 (1869) ("the state of voluntary or involuntary subjection to a master; service; the condition of a slave; slavery; bondage; hence, a state of slavish dependence").

(FN10.) The case involving the crime of holding to slavery that is most contemporaneous with the 1948 passage of § 1584 defined a slave mainly in terms of total domination of person and services and lack of freedom. United States v. Ingalls, 73 F.Supp. 76, 78-79 (SD Cal.1947).

Significantly, the Padrone statute, which encompassed coercion through other than physical or legal means, see supra, at 5-6, was designed to prevent boys from being "held in a condition of practical slavery," 42 Cong.Rec. 1122 (1908) (Sen. Lodge), or "in something kindred to slavery," 2 Cong.Rec. 2 (1873) (Sen. Sumner). See also United

States v. Ancarola, 1 F. 676, 682-683 (CC SDNY 1880) (determining whether such boys were held to involuntary servitude by relying on the defendant's control over the boys and his use of them for his profit and to the injury of their morals). These slave like conditions can presumably be contrasted with the conditions normally implicated by " 'the right of parents and guardians to the custody of their minor children or wards.' " Ante, at 2760, quoting Robertson v. Baldwin, 165 U.S. 275, 282, 17 S.Ct. 326, 329, 41 L.Ed. 715 (1897).

(FN11.) "The undoubted aim of the Thirteenth Amendment ... was not merely to end slavery but to maintain a system of completely free and voluntary labor throughout the United States.... [I]n general the defense against oppressive hours, pay, working conditions, or treatment is the right to change employers. When the master can compel and the laborer cannot escape the obligation to go on, there is no power below to redress and no incentive above to relieve a harsh overlordship or unwholesome conditions of labor." Pollock v. Williams, 322 U.S. 4, 17-18, 64 S.Ct. 792, 799, 88 L.Ed. 1095 (1944).

(FN12.) "That there may be marginal cases in which it is difficult to determine the side of the line on which a particular fact situation falls is no sufficient reason to hold the language too ambiguous to define a criminal offense." United States v. Petrillo, 332 U.S. 1, 7, 67 S. Ct. 1538, 1542, 91 L.Ed. 1877 (1947) (rejecting vagueness challenge to statute making it a crime to coerce the employment of "persons in excess of the number of employees needed"). Ambiguity over such matters of degree is not obviated by the Court's test, since it requires a determination of whether the degree of physical or legal coercion used was sufficient to compel "involuntary" service. Cf. Steward Machine Co. v. Davis, 301 U.S. 548, 590, 57 S.Ct. 883, 892, 81 L.Ed. 1279 (1937). Indeed, the Court introduces a far more profound uncertainty by adopting an understanding of "physical" coercion that encompasses a broad array of what might commonly be understood to be nonphysical forms of coercion. See n. 5, supra. Although these forms of coercion certainly deserve to be encompassed within § 1584, it is at best obscure under the Court's test what line divides the forms of coercion that are covered by § 1584 from those that are not because the Court never defines its rather unique understanding of "physical" coercion. Instead, the Court seems to use "physical" as no more than a formal label it applies to those forms of coercion it deems sufficiently egregious to criminalize. Such a mode of analysis is, of course, conclusory. Worse, it merely reintroduces all the difficulties of the Government's test in a more obscure and exacerbated form.

(FN13.) Like the Court, I put aside the exceptional cases it discusses ante, at 2760.

(FN1.) Although the Government conceded at oral argument that "a parent who coerced an adult son or daughter into working in the family business by threatening withdrawal of affection," might be in violation of the statute, ante, at 2763, I cannot believe that we need

adopt a narrow construction of § 1584 to avoid uncertainty as to such cases. No parent would expect to be prosecuted, no responsible prosecutor would seek indictment, and no reasonable jury would convict for this sort of conduct. Of course, increasingly difficult hypothetical cases can be developed to a point at which reasonable persons may disagree. No legal rule, however, produces certainty and I am convinced that § 1584 is sufficiently definite on its face to apprise the public of what it may and may not do. The seemingly unambiguous rule adopted by the majority itself admits of grey area. The Court asserts: "The history of the padrone statute reflects Congress' view that a victim's age or special vulnerability may be relevant in determining whether a particular type or a certain degree of physical or legal coercion is sufficient to hold that person to involuntary servitude." Ante, at 2762. Thus, the public is left to ask how young is too young, how vulnerable is too vulnerable, and how much coercion is permissible in light of the victim's age or vulnerability? The answer to each question, however, like the question presented in this case, is best--if not only--resolved on a case-by-case basis.

(FN2.) As the Court of Appeals noted, "[t]he trial court instructed the jury to incorporate the definition of involuntary servitude from § 1584 into § 241 which encompasses the Thirteenth Amendment." 821 F.2d 1186, 1188, n. 3 (CA6 1987). Because the parties did not challenge this process of incorporation, the Court of Appeals did not reach the question whether § 241 requires a different set of instructions from § 1584 concerning the meaning of "involuntary servitude." Ibid. Because our decision in this case does not affect the ultimate disposition--that is, a new trial is necessary in any event--I would not extend our analysis beyond the scope of the question considered by the Court of Appeals.

(FN3.) The full text of the relevant jury instructions appears as an appendix to this opinion.

(FN4.) This definition of "servitude" closely resembles the definitions found in the dictionaries that Justice BRENNAN considers in drawing the conclusion that psychological coercion is only covered by the statute if accompanied by a " 'slave like' conditio[n] of servitude." See ante, at 2769, and n. 9 ("[I]n 1910 and 1949, Webster's defined 'servitude' as the '[c]ondition of a slave; slavery; serfdom; bondage; state of compulsory subjection to a master.... In French and English Colonies of the 17th and 18th centuries, the condition of transported or colonial laborers who, under contract or by custom, rendered service with temporary and limited loss of political and personal liberty' ").

Note. This booklet does not contain any tax forms.

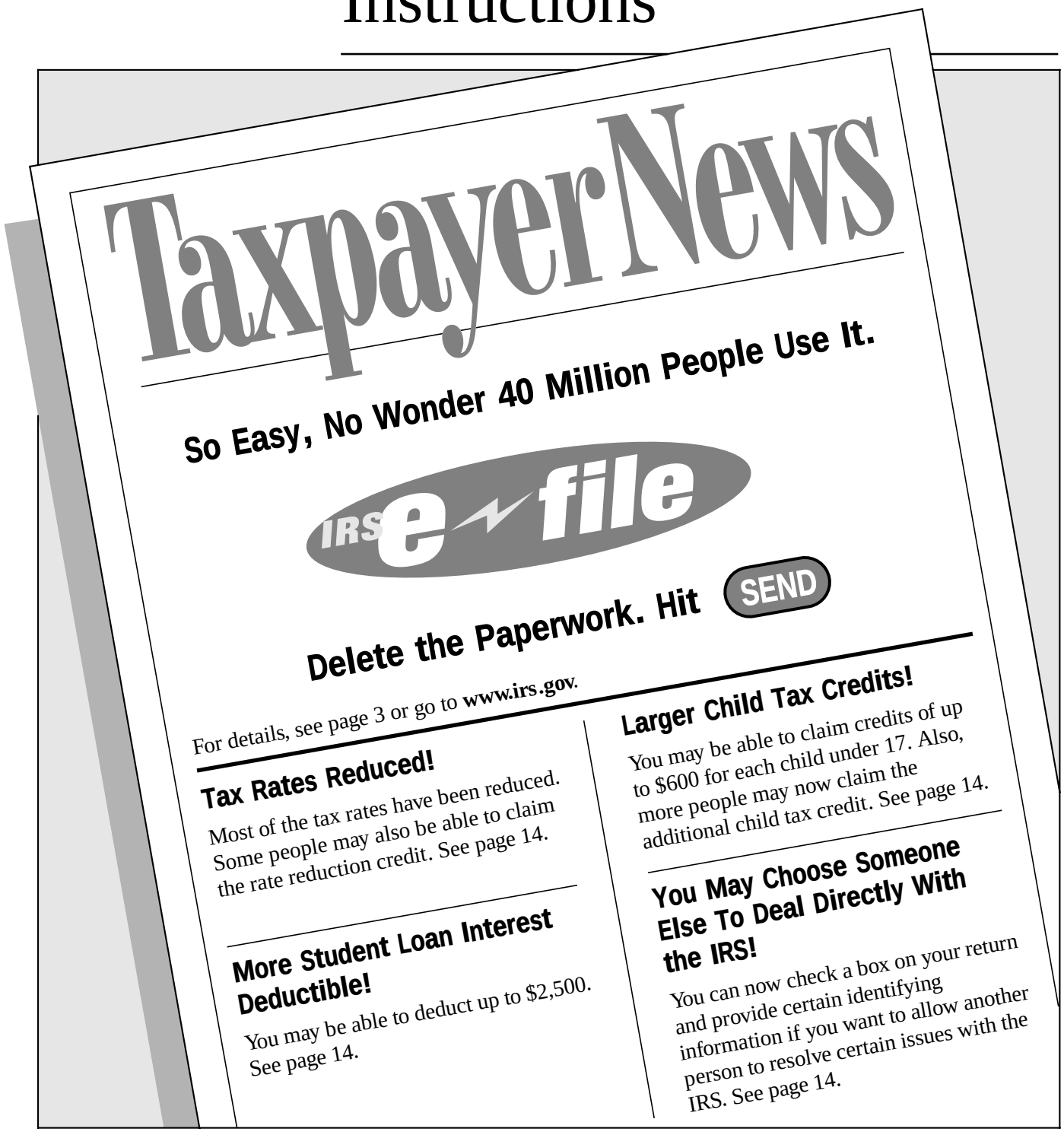
IRS

Department of the Treasury
Internal Revenue Service

www.irs.gov

2001 1040

Instructions



The Internal Revenue Service ● Working to put service first

Cat. No. 24811V

A Message From the Commissioner

Dear Taxpayer:

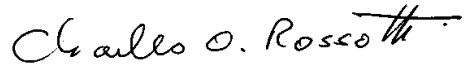
We know that preparing your tax return is not always an easy task. We at the IRS are working as hard as we can, within the limits of the law, to make filing simpler and easier for you.

Here are some of the things we have done that may help you file and pay your taxes more easily.

- If you have capital gains, we have made the tax computation on Schedule D easier for most taxpayers by removing 14 lines.
- You can designate another person (such as your preparer, relative, or friend) to discuss your return with the IRS to resolve questions that may arise in processing your return. Just fill out the Third Party Designee section on your return.
- If you have questions about how to fill out your return, you can get many of the answers 24 hours a day from our Frequently Asked Questions section on our popular web site at www.irs.gov/tax_edu/faq/index.html.
- If you need a form, you can download it directly from the IRS Web Site at www.irs.gov.
- In most cases, you can now file your return and pay your taxes electronically without any paper forms required. Just visit our web site and it will provide you a choice of many web sites on which you can prepare your return and file it with the IRS. You can use a credit or debit card to pay any balance due. Last year, over 40 million people filed electronically—and got the benefits of much faster refunds, much less chance of receiving an error notice from the IRS, and positive confirmation that their returns were received.
- If you cannot file by April 15 and need an extension to file, you can get one automatically by telephone by calling 1-888-796-1074. Remember, even if you get an extension, you still have to pay any taxes due by April 15 and you can do this by phone as well.

We know there is a lot more for us to do to serve you better and we plan many more improvements in the future. If you have specific suggestions how we can make it easier for you to file and pay your taxes, please e-mail them to us through the IRS Web Site at www.irs.gov/help/email2.html.

Sincerely,



Charles O. Rossotti

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

So Easy, No Wonder 40 Million People Love It.

- **Accuracy!** Your chance of getting an error notice from the IRS is significantly reduced.
- **Security!** Your privacy and security are assured.
- **Electronic Signatures!** Create your own Personal Identification Number (PIN) and file a completely paperless return through your tax preparation software or tax professional. There is nothing to mail!
- **Proof of Acceptance!** You receive an electronic acknowledgement within 48 hours that the IRS has accepted your return for processing.
- **Fast Refunds!** You get your refund in half the time, even faster and safer with Direct Deposit—in as few as 10 days.
- **FREE/Low-Cost Filing!** Check out the IRS Web Site at www.irs.gov for IRS *e-file* partners offering free or low-cost filing options to taxpayers who qualify.
- **Electronic Payment Options!** Convenient, safe, and secure electronic payment options are available. *e-file* and pay in a single step. Schedule an electronic funds withdrawal from your bank account (up to and including April 15, 2002) or pay by credit card.
- **Federal/State *e-file!*** Prepare and file your Federal and state returns together and double the benefits you get from *e-file.*

Get all the details on page 55 or check out the IRS Web Site at www.irs.gov.

IRS e-file

Delete the Paperwork. Hit SEND

Tax Return Page Reference

Questions about what to put on a line? Help is on the page number in the circle.

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2001 (99) IRS Use Only—Do not write or staple in this space.

Label (19) (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20

OMB No. 1545-0074

Your first name and initial | Last name | **Your social security number** (19)

If a joint return, spouse's first name and initial | Last name | **Spouse's social security number** (19)

FOR REFERENCE ONLY—DO NOT FILE

Home address (number and street). If you have a P.O. box, see page 19. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.

▲ Important! ▲ You **must** enter your SSN(s) above.

Presidential Election Campaign (See page 19.) (19) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? . . . ► **You** ☐ Yes ☐ No **Spouse** ☐ Yes ☐ No

Filing Status (19)

Check only one box.

1 ☐ Single

2 ☐ Married filing joint return (even if only one had income)

3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ►

4 ☐ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ►

5 ☐ Qualifying widow(er) with dependent child (year spouse died ►). (See page 19.)

Exemptions (19)

6a ☐ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a . . . .

b ☐ **Spouse** . . . .

c **Dependents:**

(1) First name / Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 20)
	(20)		☐ (20)
			☐
			☐
			☐
			☐
			☐

If more than six dependents, see page 20. (20)

d Total number of exemptions claimed . . . .

No. of boxes checked on 6a and 6b ____

No. of your children on 6c who:
- **lived with you** ____
- **did not live with you due to divorce or separation (see page 20)** (20) ____

Dependents on 6c not entered above ____

Add numbers entered on lines above ► ☐

Income (53)

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21. (21)

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.** (52)

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7 (21)
8a	**Taxable** interest. Attach Schedule B if required		8a (21)
b	**Tax-exempt** interest. **Do not** include on line 8a (B-1)	8b (21)	
9	Ordinary dividends. Attach Schedule B if required (B-1)		9 (21)
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)		10 (22)
11	Alimony received		11 (23)
12	Business income or (loss). Attach Schedule C or C-EZ		12 (23)
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ► ☐		13 (23)
14	Other gains or (losses). Attach Form 4797		14 (23)
15a	Total IRA distributions 15a (23)	**b** Taxable amount (see page 23)	15b (23)
16a	Total pensions and annuities 16a (23)	**b** Taxable amount (see page 23)	16b (23)
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19 (25)
20a	Social security benefits 20a (25)	**b** Taxable amount (see page 25)	20b (25)
21	Other income. List type and amount (see page 27) (27)		21
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ►		22

Adjusted Gross Income

23	IRA deduction (see page 27)	23 (27)	
24	Student loan interest deduction (see page 28)	24 (28)	
25	Archer MSA deduction. Attach Form 8853	25 (29)	
26	Moving expenses. Attach Form 3903	26 (29)	
27	One-half of self-employment tax. Attach Schedule SE	27 (30)	
28	Self-employed health insurance deduction (see page 30)	28 (30)	
29	Self-employed SEP, SIMPLE, and qualified plans	29 (30)	
30	Penalty on early withdrawal of savings	30 (30)	
31a	Alimony paid **b** Recipient's SSN ►	31a (30)	
32	Add lines 23 through 31a		32 (30)
33	Subtract line 32 from line 22. This is your **adjusted gross income** ►		33 (31)

Tax Return Page Reference

Questions about what to put on a line? Help is on the page number in the circle.

Tax and Credits

Standard Deduction for—

- People who checked any box on line 35a or 35b **or** who can be claimed as a dependent, see page 31.
- All others:

Single, $4,550

Head of household, $6,650

Married filing jointly or Qualifying widow(er), $7,600

Married filing separately, $3,800

(31)

34	Amount from line 33 (adjusted gross income)		34 (31)
35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a		(31)
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here (A-1) ▶ 35b ☐		
36	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		36 (31)
37	Subtract line 36 from line 34		37
38	If line 34 is $99,725 or less, multiply $2,900 by the total number of exemptions claimed on line 6d. If line 34 is over $99,725, see the worksheet on page 32		38 (32)
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-		39
40	**Tax** (see page 33). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972		40 (33)
41	**Alternative minimum tax** (see page 34). Attach Form 6251		41 (34)
42	Add lines 40 and 41 ▶		42
43	Foreign tax credit. Attach Form 1116 if required	43 (34)	
44	Credit for child and dependent care expenses. Attach Form 2441	44 (35)	
45	Credit for the elderly or the disabled. Attach Schedule R	45 (35)	
46	Education credits. Attach Form 8863	46 (36)	
47	Rate reduction credit. See the worksheet on page 36	47 NEW (36)	
48	Child tax credit (see page 37)	48 (37)	
49	Adoption credit. Attach Form 8839	49 (39)	
50	Other credits from: **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify) _____	50 (39)	
51	Add lines 43 through 50. These are your **total credits**		51 (39)
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0- ▶		52

Other Taxes

53	Self-employment tax. Attach Schedule SE	53
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54 (39)
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55 (39)
56	Advance earned income credit payments from Form(s) W-2	56 (39)
57	Household employment taxes. Attach Schedule H	57 (39)
58	Add lines 52 through 57. This is your **total tax** ▶	58 (39)

Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59 (40)	
60	2001 estimated tax payments and amount applied from 2000 return	60 (40)	
61a	**Earned income credit (EIC)**	61a (41)	
b	Nontaxable earned income 61b (43)		
62	Excess social security and RRTA tax withheld (see page 51)	62 (51)	
63	Additional child tax credit. Attach Form 8812	63 (51)	
64	Amount paid with request for extension to file (see page 51)	64 (51)	
65	Other payments. Check if from **a** ☐ Form 2439 **b** ☐ Form 4136	65 (51)	
66	Add lines 59, 60, 61a, and 62 through 65. These are your **total payments** ▶		66

Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

67	If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you **overpaid**		67 (51)
68a	Amount of line 67 you want **refunded to you** (51) ▶		68a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
69	Amount of line 67 you want **applied to your 2002 estimated tax** ▶ 69		

Amount You Owe

70	**Amount you owe.** Subtract line 66 from line 58. For details on how to pay, see page 52 ▶		70 (52)
71	Estimated tax penalty. Also include on line 70	71 (52)	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ NEW (53) Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 19. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature (53)	Date	Your occupation	Daytime phone number ( ) (53)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature (53)	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

IRS Customer Service Standards

At the IRS, our goal is to continually improve the quality of our services. To achieve that goal, we have developed customer service standards in the following areas:

- **Easier filing and payment options**
- **Access to information**
- **Accuracy**
- **Prompt refunds**
- **Initial contact resolution**
- **Canceling penalties**
- **Resolving problems**
- **Simpler forms**

If you would like information about the IRS standards and a report of our accomplishments, see **Pub. 2183.**

Help With Unresolved Tax Issues

Office of the Taxpayer Advocate

Contacting Your Taxpayer Advocate

If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels.

While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

Handling Your Tax Problems

Your assigned personal advocate will listen to your point of view and will work with you to address your concerns. You can expect the advocate to provide you with:

- A "fresh look" at your new or on-going problem
- Timely acknowledgment
- The name and phone number of the individual assigned to your case
- Updates on progress
- Timeframes for action
- Speedy resolution
- Courteous service

Information You Should Be Prepared To Provide

- Your name, address, and social security number (or employer identification number)
- Your telephone number and hours you can be reached
- The type of tax return and year(s) involved
- A detailed description of your problem
- Your previous attempts to solve the problem and the office you contacted, and
- Description of the hardship you are facing (if applicable)

How To Contact Your Taxpayer Advocate

- Call the Taxpayer Advocate's toll-free number: **1-877-777-4778**
- Call, write, or fax the Taxpayer Advocate office in your area (see **Pub. 1546** for addresses and phone numbers)
- TTY/TDD help is available by calling 1-800-829-4059

Quick and Easy Access to Tax Help and Forms

Note. If you live outside the United States, see **Pub. 54** to find out how to get help and forms.

Personal Computer

You can access the IRS Web Site 24 hours a day, 7 days a week, at **www.irs.gov** to:

- Download forms, instructions, and publications
- See answers to frequently asked tax questions
- Search publications on-line by topic or keyword
- Figure your withholding allowances using our W-4 calculator
- Send us comments or request help by e-mail
- Sign up to receive local and national tax news by e-mail

You can also reach us using File Transfer Protocol at ftp.irs.gov

Fax

You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703-368-9694** from the telephone connected to the fax machine. See pages 8 and 9 for a list of the items available.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608.**

Long-distance charges may apply.

Mail

You can order forms, instructions, and publications by completing the order blank on page 57. You should receive your order within 10 days after we receive your request.

Phone

You can order forms and publications and receive automated information 24 hours a day, 7 days a week, by phone.

Forms and Publications

Call **1-800-TAX-FORM** (1-800-829-3676) to order current year forms, instructions, and publications, and prior year forms and instructions. You should receive your order within 10 days.

TeleTax Topics

Call **1-800-829-4477** to listen to pre-recorded messages covering about 150 tax topics. See pages 11 and 12 for a list of the topics.

Refund Information

You can check the status of your 2001 refund using TeleTax's Refund Information service. See page 11.

Walk-In

You can pick up some of the most requested forms, instructions, and publications at many IRS offices, post offices, and libraries. Some IRS offices, libraries, city and county government offices, credit unions, grocery stores, office supply stores, and copy centers have an extensive collection of products available to photocopy or print from a CD-ROM.

CD-ROM

Order **Pub. 1796,** Federal Tax Products on CD-ROM, and get:

- Current year forms, instructions, and publications
- Prior year forms, instructions, and publications
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping
- The Internal Revenue Bulletin

Buy the CD-ROM on the Internet at **www.irs.gov/cdorders** from the National Technical Information Service (NTIS) for $21 (no handling fee) or call **1-877-CDFORMS** (1-877-233-6767) toll free to buy the CD-ROM for $21 (plus a $5 handling fee).

You can also get help in other ways—See page 56 for information.

Forms by Fax

The following forms and instructions are available through our **Tax Fax** service 24 hours a day, 7 days a week. Just call **703-368-9694** from the telephone connected to the fax machine. Long-distance charges may apply. When you call, you will hear instructions on how to use the service. Select the option for getting forms. Then, enter the **Catalog Number** (Cat. No.) shown below for each item you want. When you hang up the phone, the fax will begin.

Name of Form or Instructions	Title of Form or Instructions	Cat. No.	No. of Pages
Form SS-4	Application for Employer Identification Number	16055	2
Instr. SS-4		62736	6
Form SS-8	Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding	16106	5
Form W-2c	Corrected Wage and Tax Statement	61437	8
Form W-3c	Transmittal of Corrected Wage and Tax Statements	10164	2
Instr. W-2c and W-3c		25978	4
Form W-4	Employee's Withholding Allowance Certificate	10220	2
Form W-4P	Withholding Certificate for Pension or Annuity Payments	10225	4
Form W-5	Earned Income Credit Advance Payment Certificate	10227	3
Form W-7	Application for IRS Individual Taxpayer Identification Number	10229	3
Form W-7A	Application for Taxpayer Identification Number for Pending U.S. Adoptions	24309	2
Form W-7P	Application for Preparer Tax Identification Number	26781	1
Form W-9	Request for Taxpayer Identification Number and Certification	10231	2
Instr. W-9		20479	2
Form W-9S	Request for Student's or Borrower's Taxpayer Identification Number and Certification	25240	2
Form W-10	Dependent Care Provider's Identification and Certification	10437	1
Form 709	U.S. Gift (and Generation-Skipping Transfer) Tax Return	16783	4
Instr. 709		16784	12
Form 709A	U.S. Short Form Gift Tax Return	10171	3
Form 843	Claim for Refund and Request for Abatement	10180	1
Instr. 843		11200	2
Form 940	Employer's Annual Federal Unemployment (FUTA) Tax Return	11234	2
Instr. 940		13660	6
Form 940-EZ	Employer's Annual Federal Unemployment (FUTA) Tax Return	10983	2
Instr. 940-EZ		25947	5
Form 941	Employer's Quarterly Federal Tax Return	17001	4
Instr. 941		14625	4
Form 941c	Supporting Statement To Correct Information	11242	4
Form 990	Return of Organization Exempt From Income Tax	11282	6
Instr. 990 & 990-EZ	General Instructions for Forms 990 and 990-EZ	22386	14
Instr. 990	Specific Instructions for Form 990	50002	18
Schedule A (Form 990 or 990-EZ)	Organization Exempt Under Section 501(c)(3)	11285	6
Instr. Sch. A		11294	14
Form 990-EZ	Short Form Return of Organization Exempt From Income Tax	10642	2
Instr. 990-EZ	Specific Instructions for Form 990-EZ	50003	9
Form 1040	U.S. Individual Income Tax Return	11320	2
Instr. 1040	Line Instructions for Form 1040	11325	34
Instr. 1040	General Information for Form 1040	24811	26
Tax Table and Tax Rate Sch.	Tax Table and Tax Rate Schedules (Form 1040)	24327	13
Schedules A&B (Form 1040)	Itemized Deductions & Interest and Ordinary Dividends	11330	2
Instr. Sch. A&B		24328	8
Schedule C (Form 1040)	Profit or Loss From Business (Sole Proprietorship)	11334	2
Instr. Sch. C		24329	8
Schedule C-EZ (Form 1040)	Net Profit From Business (Sole Proprietorship)	14374	2
Schedule D (Form 1040)	Capital Gains and Losses	11338	2
Instr. Sch. D		24331	9
Schedule D-1 (Form 1040)	Continuation Sheet for Schedule D	10424	2
Schedule E (Form 1040)	Supplemental Income and Loss	11344	2
Instr. Sch. E		24332	6
Schedule EIC (Form 1040A or 1040)	Earned Income Credit	13339	2
Schedule F (Form 1040)	Profit or Loss From Farming	11346	2
Instr. Sch. F		24333	6
Schedule H (Form 1040)	Household Employment Taxes	12187	2
Instr. Sch. H		21451	8
Schedule J (Form 1040)	Farm Income Averaging	25513	1
Instr. Sch. J		25514	7
Schedule R (Form 1040)	Credit for the Elderly or the Disabled	11359	2
Instr. Sch. R		11357	4
Schedule SE (Form 1040)	Self-Employment Tax	11358	2
Instr. Sch. SE		24334	4
Form 1040A	U.S. Individual Income Tax Return	11327	2
Schedule 1 (Form 1040A)	Interest and Ordinary Dividends for Form 1040A Filers	12075	1
Schedule 2 (Form 1040A)	Child and Dependent Care Expenses for Form 1040A Filers	10749	2
Instr. Sch. 2		30139	3
Schedule 3 (Form 1040A)	Credit for the Elderly or the Disabled for Form 1040A Filers	12064	2
Instr. Sch. 3		12059	4
Form 1040-ES	Estimated Tax for Individuals	11340	7
Form 1040EZ	Income Tax Return for Single and Joint Filers With No Dependents	11329	2

Name of Form or Instructions	Title of Form or Instructions	Cat. No.	No. of Pages
Form 1040NR	U.S. Nonresident Alien Income Tax Return	11364	5
Instr. 1040NR		11368	40
Form 1040NR-EZ	U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents	21534	2
Instr. 1040NR-EZ		21718	16
Form 1040-V	Payment Voucher	20975	2
Form 1040X	Amended U.S. Individual Income Tax Return	11360	2
Instr. 1040X		11362	6
Form 1116	Foreign Tax Credit	11440	2
Instr. 1116		11441	12
Form 1310	Statement of Person Claiming Refund Due a Deceased Taxpayer	11566	2
Form 2106	Employee Business Expenses	11700	2
Instr. 2106		64188	4
Form 2106-EZ	Unreimbursed Employee Business Expenses	20604	2
Form 2120	Multiple Support Declaration	11712	1
Form 2210	Underpayment of Estimated Tax by Individuals, Estates, and Trusts	11744	3
Instr. 2210		63610	6
Form 2290	Heavy Highway Vehicle Use Tax Return	11250	3
Instr. 2290		27231	8
Form 2441	Child and Dependent Care Expenses	11862	2
Instr. 2441		10842	3
Form 2553	Election by a Small Business Corporation	18629	2
Instr. 2553		49978	4
Form 2555	Foreign Earned Income	11900	3
Instr. 2555		11901	4
Form 2555-EZ	Foreign Earned Income Exclusion	13272	2
Instr. 2555-EZ		14623	3
Form 2688	Application for Additional Extension of Time To File U.S. Individual Income Tax Return	11958	2
Form 2848	Power of Attorney and Declaration of Representative	11980	2
Instr. 2848		11981	4
Form 3903	Moving Expenses	12490	2
Form 4136	Credit for Federal Tax Paid on Fuels	12625	4
Form 4137	Social Security and Medicare Tax on Unreported Tip Income	12626	2
Form 4506	Request for Copy or Transcript of Tax Form	41721	2
Form 4562	Depreciation and Amortization	12906	2
Instr. 4562		12907	12
Form 4684	Casualties and Thefts	12997	2
Instr. 4684		12998	4
Form 4797	Sales of Business Property	13086	2
Instr. 4797		13087	7
Form 4835	Farm Rental Income and Expenses	13117	2
Form 4868	Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141	4
Form 4952	Investment Interest Expense Deduction	13177	2
Form 4972	Tax on Lump-Sum Distributions	13187	4
Form 5329	Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts	13329	2
Instr. 5329		13330	4
Form 6198	At-Risk Limitations	50012	1
Instr. 6198		50013	8
Form 6251	Alternative Minimum Tax—Individuals	13600	2
Instr. 6251		64277	8
Form 6252	Installment Sale Income	13601	4
Form 6781	Gains and Losses From Section 1256 Contracts and Straddles	13715	3
Form 8271	Investor Reporting of Tax Shelter Registration Number	61924	2
Form 8283	Noncash Charitable Contributions	62299	2
Instr. 8283		62730	4
Form 8300	Report of Cash Payments Over $10,000 Received in a Trade or Business	62133	4
Form 8332	Release of Claim to Exemption for Child of Divorced or Separated Parents	13910	1
Form 8379	Injured Spouse Claim and Allocation	62474	2
Form 8582	Passive Activity Loss Limitations	63704	3
Instr. 8582		64294	12
Form 8586	Low-Income Housing Credit	63987	2
Form 8606	Nondeductible IRAs and Coverdell ESAs	63966	2
Instr. 8606		25399	8
Form 8615	Tax for Children Under Age 14 With Investment Income of More Than $1,500	64113	1
Instr. 8615		28914	2
Form 8718	User Fee for Exempt Organization Determination Letter Request	64728	1
Form 8801	Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts	10002	4
Form 8809	Request for Extension of Time To File Information Returns	10322	2
Form 8812	Additional Child Tax Credit	10644	2
Form 8814	Parents' Election To Report Child's Interest and Dividends	10750	2
Form 8815	Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989	10822	2
Form 8822	Change of Address	12081	2
Form 8824	Like-Kind Exchanges	12311	4
Form 8829	Expenses for Business Use of Your Home	13232	1
Instr. 8829		15683	4
Form 8839	Qualified Adoption Expenses	22843	2
Instr. 8839		23077	4
Form 8850	Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits	22851	2
Instr. 8850		24833	2
Form 8853	Archer MSAs and Long-Term Care Insurance Contracts	24091	2
Instr. 8853		24188	8
Form 8857	Request for Innocent Spouse Relief	24647	4
Form 8859	District of Columbia First-Time Homebuyer Credit	24779	2
Form 8862	Information To Claim Earned Income Credit After Disallowance	25145	2
Instr. 8862		25343	2
Form 8863	Education Credits	25379	3
Form 9465	Installment Agreement Request	14842	2

Partial List of Publications

The following publications are available through the IRS Web Site 24 hours a day, 7 days a week, at **www.irs.gov.** You can also order publications by calling **1-800-TAX-FORM** (1-800-829-3676) or by completing the order blank on page 57. You should receive your order within 10 days after we receive your request. For a complete list of available publications, see **Pub. 910.**

Pub. No.	Title
1	Your Rights as a Taxpayer
3	Armed Forces' Tax Guide
17	Your Federal Income Tax (For Individuals)
225	Farmer's Tax Guide
334	Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
378	Fuel Tax Credits and Refunds
463	Travel, Entertainment, Gift, and Car Expenses
501	Exemptions, Standard Deduction, and Filing Information
502	Medical and Dental Expenses
503	Child and Dependent Care Expenses
504	Divorced or Separated Individuals
505	Tax Withholding and Estimated Tax
508	Tax Benefits for Work-Related Education
509	Tax Calendars for 2002
514	Foreign Tax Credit for Individuals
516	U.S. Government Civilian Employees Stationed Abroad
517	Social Security and Other Information for Members of the Clergy and Religious Workers
519	U.S. Tax Guide for Aliens
520	Scholarships and Fellowships
521	Moving Expenses
523	Selling Your Home
524	Credit for the Elderly or the Disabled
525	Taxable and Nontaxable Income
526	Charitable Contributions
527	Residential Rental Property
529	Miscellaneous Deductions
530	Tax Information for First-Time Homeowners
531	Reporting Tip Income
533	Self-Employment Tax
534	Depreciating Property Placed in Service Before 1987
535	Business Expenses
537	Installment Sales
541	Partnerships
544	Sales and Other Dispositions of Assets
547	Casualties, Disasters, and Thefts
550	Investment Income and Expenses
551	Basis of Assets
552	Recordkeeping for Individuals
553	Highlights of 2001 Tax Changes
554	Older Americans' Tax Guide
555	Community Property
556	Examination of Returns, Appeal Rights, and Claims for Refund
559	Survivors, Executors, and Administrators
561	Determining the Value of Donated Property
564	Mutual Fund Distributions
570	Tax Guide for Individuals With Income From U.S. Possessions
575	Pension and Annuity Income
584	Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
587	Business Use of Your Home (Including Use by Day-Care Providers)
590	Individual Retirement Arrangements (IRAs)
593	Tax Highlights for U.S. Citizens and Residents Going Abroad
594	The IRS Collection Process
595	Tax Highlights for Commercial Fishermen
596	Earned Income Credit (EIC)
721	Tax Guide to U.S. Civil Service Retirement Benefits
901	U.S. Tax Treaties
907	Tax Highlights for Persons With Disabilities
908	Bankruptcy Tax Guide
910	Guide To Free Tax Services
911	Direct Sellers
915	Social Security and Equivalent Railroad Retirement Benefits
919	How Do I Adjust My Tax Withholding?
925	Passive Activity and At-Risk Rules
926	Household Employer's Tax Guide
929	Tax Rules for Children and Dependents
936	Home Mortgage Interest Deduction
946	How To Depreciate Property
947	Practice Before the IRS and Power of Attorney
950	Introduction to Estate and Gift Taxes
967	The IRS Will Figure Your Tax
968	Tax Benefits for Adoption
970	Tax Benefits for Higher Education
971	Innocent Spouse Relief
972	Child Tax Credit
1542	Per Diem Rates
1544	Reporting Cash Payments of Over $10,000
1546	The Taxpayer Advocate Service of the IRS
3920	Tax Relief for Victims of Terrorist Attacks

Spanish Language Publications

1SP	Your Rights as a Taxpayer
579SP	How To Prepare Your Federal Income Tax Return
594SP	The IRS Collection Process
596SP	Earned Income Credit
850	English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP	Reporting Cash Payments of Over $10,000

What Is TeleTax?

Call TeleTax at **1-800-829-4477** for:

- **Refund information.** Check the status of your **2001** refund.
- **Recorded tax information.** There are about 150 topics that answer many Federal tax questions.
- **2001 advance payment (rebate) information.** Find out the amount of your advance payment (before offset). You may need this information to complete the Rate Reduction Credit Worksheet on page 36.

How Do You Use TeleTax?

Refund Information

Refund information is not available until at least 4 weeks after you file your return (3 weeks if you file electronically), and sometimes is not available for up to 6 weeks. Please wait at least 4 weeks from the date you filed before calling to check the status of your refund. Do not send in a copy of your return unless asked to do so.

Be sure to have a copy of your 2001 tax return available because you will need to know the first social security number shown on your return, the filing status, and the **exact** whole-dollar amount of your refund. Then, call **1-800-829-4477** and follow the recorded instructions.

Refunds are sent out weekly on Fridays. If you call to check the status of your refund and are not given the date it will be issued, please wait until the next week before calling back.

Recorded Tax Information

Recorded tax information is available 24 hours a day, 7 days a week. Select the number of the topic you want to hear. Then, call **1-800-829-4477.** Have paper and pencil handy to take notes.

Topics by Personal Computer

TeleTax topics are also available using a personal computer and modem (go to **www.irs.gov**).

TeleTax Topics

All topics are available in Spanish.

Topic No. — Subject

IRS Help Available

101 IRS services—Volunteer tax assistance, toll-free telephone, walk-in assistance, and outreach programs
102 Tax assistance for individuals with disabilities and the hearing impaired
103 Intro. to Federal taxes for small businesses/self-employed
104 Taxpayer Advocate program—Help for problem situations
105 Public libraries—Tax information tapes and reproducible tax forms

IRS Procedures

151 Your appeal rights
152 Refunds—How long they should take
153 What to do if you haven't filed your tax return (Nonfilers)
154 Form W-2—What to do if not received
155 Forms and Publications—How to order
156 Copy of your tax return—How to get one
157 Change of address—How to notify IRS
158 Ensuring proper credit of payments

Collection

201 The collection process
202 What to do if you can't pay your tax
203 Failure to pay child support and Federal nontax and state income tax obligations
204 Offers in compromise
205 Innocent spouse relief

Alternative Filing Methods

251 Signing your return with a self-select PIN
252 Electronic filing
253 Substitute tax forms
254 How to choose a paid tax preparer
255 TeleFile

General Information

301 When, where, and how to file
302 Highlights of tax changes
303 Checklist of common errors when preparing your tax return
304 Extensions of time to file your tax return
305 Recordkeeping
306 Penalty for underpayment of estimated tax
307 Backup withholding
308 Amended returns
309 Roth IRA contributions
310 Coverdell education savings accounts
311 Power of attorney information

Filing Requirements, Filing Status, and Exemptions

351 Who must file?
352 Which form—1040, 1040A, or 1040EZ?
353 What is your filing status?
354 Dependents
355 Estimated tax
356 Decedents

Types of Income

401 Wages and salaries
402 Tips
403 Interest received
404 Dividends
405 Refunds of state and local taxes
406 Alimony received
407 Business income
408 Sole proprietorship
409 Capital gains and losses
410 Pensions and annuities
411 Pensions—The general rule and the simplified method
412 Lump-sum distributions
413 Rollovers from retirement plans
414 Rental income and expenses
415 Renting vacation property and renting to relatives
416 Farming and fishing income
417 Earnings for clergy
418 Unemployment compensation
419 Gambling income and expenses
420 Bartering income

(Continued on page 12)

TeleTax Topics

(Continued)

Topic No.	Subject
421	Scholarship and fellowship grants
422	Nontaxable income
423	Social security and equivalent railroad retirement benefits
424	401(k) plans
425	Passive activities—Losses and credits
426	Other income
427	Stock options
428	Roth IRA distributions
429	Traders
430	Demutualization
431	Sale of assets held for more than 5 years
	Adjustments to Income
451	Individual retirement arrangements (IRAs)
452	Alimony paid
453	Bad debt deduction
454	Tax shelters
455	Moving expenses
456	Student loan interest deduction
457	Deduction for higher education expenses (for 2002)
	Itemized Deductions
501	Should I itemize?
502	Medical and dental expenses
503	Deductible taxes
504	Home mortgage points
505	Interest expense
506	Contributions
507	Casualty and theft losses
508	Miscellaneous expenses
509	Business use of home
510	Business use of car
511	Business travel expenses
512	Business entertainment expenses
513	Educational expenses
514	Employee business expenses
515	Disaster area losses
	Tax Computation
551	Standard deduction
552	Tax and credits figured by the IRS
553	Tax on a child's investment income
554	Self-employment tax
555	Ten-year tax option for lump-sum distributions
556	Alternative minimum tax
557	Tax on early distributions from traditional and Roth IRAs
558	Tax on early distributions from retirement plans
	Tax Credits
601	Earned income credit (EIC)
602	Child and dependent care credit
603	Credit for the elderly or the disabled
604	Advance earned income credit
605	Education credits
606	Child tax credits
607	Adoption credit
608	Excess social security and RRTA tax withheld
609	Rate reduction credit
	IRS Notices
651	Notices—What to do
652	Notice of underreported income—CP 2000
653	IRS notices and bills, penalties, and interest charges
	Basis of Assets, Depreciation, and Sale of Assets
701	Sale of your home
703	Basis of assets
704	Depreciation
705	Installment sales
	Employer Tax Information
751	Social security and Medicare withholding rates
752	Form W-2—Where, when, and how to file
753	Form W-4—Employee's Withholding Allowance Certificate
754	Form W-5—Advance earned income credit
755	Employer identification number (EIN)—How to apply
756	Employment taxes for household employees
757	Form 941—Deposit requirements
758	Form 941—Employer's Quarterly Federal Tax Return
759	Form 940 and 940-EZ—Deposit requirements
760	Form 940 and Form 940-EZ—Employer's Annual Federal Unemployment Tax Returns
761	Tips—Withholding and reporting
762	Independent contractor vs. employee
	Magnetic Media Filers—1099 Series and Related Information Returns
801	Who must file magnetically
802	Applications, forms, and information
803	Waivers and extensions
804	Test files and combined Federal and state filing
805	Electronic filing of information returns
	Tax Information for Aliens and U.S. Citizens Living Abroad
851	Resident and nonresident aliens
852	Dual-status alien
853	Foreign earned income exclusion—General
854	Foreign earned income exclusion—Who qualifies?
855	Foreign earned income exclusion—What qualifies?
856	Foreign tax credit
857	Individual Taxpayer Identification Number—Form W-7
858	Alien tax clearance
	Tax Information for Puerto Rico Residents (in Spanish only)
901	Who must file a U.S. income tax return in Puerto Rico
902	Deductions and credits for Puerto Rico filers
903	Federal employment taxes in Puerto Rico
904	Tax assistance for Puerto Rico residents

Topic numbers are effective January 1, 2002.

Calling the IRS

If you cannot answer your question by using one of the methods listed on page 7, please call us for assistance at **1-800-829-1040.** You will not be charged for the call unless your phone company charges you for local calls. Our normal hours of operation are Monday through Friday from 7:00 a.m. to 10:00 p.m. local time. Beginning December 31, 2001, through April 16, 2002, assistance will also be available on Saturday from 9:00 a.m. to 5:00 p.m. local time. Assistance provided to callers from Alaska and Hawaii will be based on the hours of operation in the Pacific Time zone.

If you want to check the status of your **2001 refund,** call **TeleTax** at **1-800-829-4477** (see page 11 for instructions).

Employee Plans. If you own a business and have questions about starting a pension or other employee plan, an existing plan, or filing **Form 5500**, call our **Tax Exempt/Government Entities Customer Account Services** at **1-877-829-5500.** Assistance is available Monday through Friday from 8:00 a.m. to 9:30 p.m. EST. If you have questions about an individual retirement arrangement (IRA), call **1-800-829-1040.**

Exempt Organizations. If you have questions about exempt organizations, including the types of tax-exempt organizations, or you want to verify an organization's charitable status, call our **Tax Exempt/Government Entities Customer Account Services** at **1-877-829-5500.** Assistance is available Monday through Friday from 8:00 a.m. to 9:30 p.m. EST.

Before You Call

IRS representatives care about the quality of the service we provide to you, our customer. You can help us provide accurate, complete answers to your questions by having the following information available.

- The tax form, schedule, or notice to which your question relates.
- The facts about your particular situation. The answer to the same question often varies from one taxpayer to another because of differences in their age, income, whether they can be claimed as a dependent, etc.
- The name of any IRS publication or other source of information that you used to look for the answer.

To maintain your account security, you may be asked for the following information, which you should also have available.

- Your social security number.
- The amount of refund and filing status shown on your tax return.
- The "Caller ID Number" shown at the top of any notice you received.
- Your personal identification number (PIN) if you have one.
- Your date of birth.
- The numbers in your street address.
- Your ZIP code.

If you are asking for an installment agreement to pay your tax, you will be asked for the highest amount you can pay each month and the date on which you can pay it.

Evaluation of Services Provided. The IRS uses several methods to evaluate the quality of this telephone service. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Making the Call

Call **1-800-829-1040** (for TTY/TDD help, call 1-800-829-4059). We have redesigned our menus to allow callers with pulse or rotary dial telephones to speak their responses when requested to do so. First, you will be provided a series of options that will request touch-tone responses. If a touch-tone response is not received, you will then hear a series of options and be asked to speak your selections. After your touch-tone or spoken response is received, the system will direct your call to the appropriate assistance. You can do the following within the system.

- Order tax forms and publications.
- Find out the status of your refund or what you owe.
- Determine if we have adjusted your account or received payments you made.
- Request a transcript of your account.
- Find out where to send your tax return or payment.
- Request more time to pay or set up a monthly installment agreement.

Before You Hang Up

If you do not fully understand the answer you receive, or you feel our representative may not fully understand your question, our representative needs to know this. He or she will be happy to take additional time to be sure your question is answered fully.

By law, you are responsible for paying your share of Federal income tax. If we should make an error in answering your question, you are still responsible for the payment of the correct tax. Should this occur, however, you will not be charged any penalty.

Before You Fill In Form 1040

See **How To Avoid Common Mistakes** on page 54.

If you were in the Kosovo or Persian Gulf area (for example, you supported operations in a qualified hazardous duty area), see **Pub. 3.**

TIP For details on the changes for 2001 and 2002, see **Pub. 553.**

What's New for 2001?

Tax Rates Reduced. Most of the tax rates have been reduced and are reflected in the Tax Table that begins on page 59 and the Tax Rate Schedules on page 71. In addition, a new 10% tax rate applies to certain dependents. **Dependents** may be able to use the **Tax Computation Worksheet for Certain Dependents** to figure their tax. This worksheet gives the benefit of a new 10% rate. See the instructions for line 40 that begin on page 33. Dependents cannot take the rate reduction credit mentioned below.

Rate Reduction Credit. You may be able to take a new credit of up to the amount shown below for your 2001 filing status. But you cannot take this credit if you received (before offset) an advance payment of your 2001 taxes that was equal to or more than the amount shown below. See the worksheet on page 36.

- Single or married filing separately—$300
- Head of household—$500
- Married filing jointly or qualifying widow(er)—$600

Advance Payment Not Taxable. Any amount you received as an advance payment of your 2001 taxes is not taxable and should not be reported on your return.

Larger Child Tax Credits. If you have at least one child who was under age 17 at the end of 2001, you may be able to take a credit on line 48 of up to $600 for each qualifying child. You may also be able to take the additional child tax credit on line 63 if your credit on line 48 is less than $600 for each qualifying child. See the instructions for line 48 that begin on page 37 and the instructions for line 63 on page 51.

Student Loan Interest Deduction. If you paid interest on a qualified student loan, you may be able to deduct up to $2,500 of the interest. See the instructions for line 24 that begin on page 28.

Third Party Designee. If you want to allow the IRS to discuss your 2001 tax return with a family member, friend, or any other person you choose, check the "Yes" box in the Third Party Designee area of your return and enter the requested information. See page 53 for details.

Schedule D Tax Computation Simplified. To make the tax computation easier for most people with capital gains, 14 lines have been removed from Part IV of Schedule D.

IRA Deduction. You may be able to take an IRA deduction if you were covered by a retirement plan and your modified adjusted gross income is less than $43,000 ($63,000 if married filing jointly or qualifying widow(er)). See the instructions for line 23 that begin on page 27.

Education (Ed) IRAs. Ed IRAs are now called Coverdell education savings accounts (ESAs).

Earned Income Credit (EIC). You may be able to take this credit if you earned less than $32,121 (less than $10,710 if you do not have any qualifying children). See the instructions for lines 61a and 61b that begin on page 41.

Alternative Minimum Tax (AMT). The AMT exemption amounts have been increased. See the instructions for line 41 that begin on page 34.

Standard Mileage Rates. The rate for business use of your vehicle is 34½ cents a mile. The rate for use of your vehicle to get medical care is 12 cents a mile.

Mailing Your Return. You may be mailing your return to a different address this year because the IRS has changed the filing location for several areas. If you received an envelope with your tax package, please use it. Otherwise, see **Where Do You File?** on the back cover.

Tax Relief for Victims of Terrorist Attacks. See **Pub. 3920.**

Other Information

Did You Convert an IRA to a Roth IRA in 1998? If you did, see **1998 Roth IRA Conversions** on page 23 to find out the taxable amount you must report in 2001 on line 15b.

Parent of a Kidnapped Child. The parent of a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a family member may be able to take the child into account in determining his or her eligibility for the head of household or qualifying widow(er) filing status, deduction for dependents, child tax credit, and the earned income credit (EIC). For details, see **Pub. 501** (**Pub. 596** for the EIC).

Payments to Holocaust Victims. Restitution payments received by holocaust victims or their heirs after 1999 (and certain interest earned on the payments) are not taxable. If you reported these amounts on your 2000 return or used them to compute any amount affecting your 2000 tax liability, you may need to file **Form 1040X** to amend your 2000 return. For more details, see **Pub. 525.**

What To Look for in 2002

Reduced Tax Rates. Most of the tax rates will decrease by ½% and a new 10% tax rate will apply to all filers.

New Deduction for Higher Education Expenses. You may be able to deduct up to $3,000 of the qualified education expenses you pay for yourself, your spouse, or your dependents if your 2002 modified AGI is $130,000 or less.

New Credit for Elective Deferrals and IRA Contributions. You may be able to take a credit of up to $1,000 for qualified retirement savings contributions if your 2002 modified AGI is $50,000 or less.

IRA Deduction Expanded. You, and your spouse if filing jointly, may be able to take an IRA deduction of up to $3,000 ($3,500 if you will be age 50 or older at the end of 2002). If you are covered by a retirement plan, you may be able to take an IRA deduction if your 2002 modified AGI is less than $44,000 ($64,000 if married filing jointly or qualifying widow(er)).

Student Loan Interest Deduction. The 60-month limit will no longer apply and the modified AGI limit will increase.

Self-Employed Health Insurance Deduction. You may be able to deduct up to 70% of your health insurance expenses.

Adoption Credit. You may be able to take a credit of up to $10,000 for the qualified adoption expenses you pay to adopt a child.

EIC Computation Simplified. Nontaxable earned income and modified AGI will not be taken into account in determining if you are eligible for the credit or the amount of your credit.

Coverdell ESAs. You may be able to contribute up to $2,000 to a Coverdell ESA.

Filing Requirements

These rules apply to all U.S. citizens, regardless of where they live, and resident aliens.

Do You Have To File?

Use **Chart A, B,** or **C** to see if you must file a return. U.S. citizens who lived in or had income from a U.S. possession should see **Pub. 570.** Residents of Puerto Rico can use TeleTax topic 901 (see page 11) to see if they must file.

Even if you do not otherwise have to file a return, you should file one to get a refund of any Federal income tax withheld. You should also file if you are eligible for the earned income credit or the additional child tax credit.

Exception for Children Under Age 14. If you are planning to file a return for your child who was under age 14 on January 1, 2002, and certain other conditions apply, you may elect to report your child's income on your return. But you must use **Form 8814** to do so. If you make this election, your child does not have to file a return. For details, use TeleTax topic 553 (see page 11) or see Form 8814.

Nonresident Aliens and Dual-Status Aliens. These rules also apply to nonresident aliens and dual-status aliens who were married to U.S. citizens or residents at the end of 2001 and who have elected to be taxed as resident aliens. Other nonresident aliens and dual-status aliens have different filing requirements. They may have to file **Form 1040NR** or **Form 1040NR-EZ.** Specific rules apply to determine if you are a resident or nonresident alien. See **Pub. 519** for details, including the rules for students and scholars who are aliens.

When Should You File?

Not later than **April 15, 2002.** If you file after this date, you may have to pay interest and penalties. See page 56.

What if You Cannot File on Time?

You can get an automatic 4-month extension if, by April 15, 2002, you **either:**

- File **Form 4868 or**
- File for an extension by phone, using tax software, or through a tax professional.

If you expect to owe tax with your return, you can even pay part or all of it by electronic funds withdrawal or credit card (American Express® Card, Discover® Card, or MasterCard® card). See Form 4868 for details.

An automatic 4-month extension to file does not extend the time to pay your tax. See Form 4868.

If you are a U.S. citizen or resident, you may qualify for an automatic extension of time to file without filing Form 4868 or filing for an extension by phone, using tax software, or through a tax professional. You qualify if, on the due date of your return, you meet one of the following conditions.

- You live outside the United States and Puerto Rico **and** your main place of business or post of duty is outside the United States and Puerto Rico.
- You are in military or naval service on duty outside the United States and Puerto Rico.

This extension gives you an extra 2 months to file and pay the tax, but interest will be charged from the original due date of the return on any unpaid tax. You must attach a statement to your return showing that you meet the requirements.

Where Do You File?

See the back cover of this booklet for filing instructions and addresses. For details on using a private delivery service to mail your return or payment, see page 18.

Chart A—For Most People

IF your filing status is . . .	AND at the end of 2001 you were* . . .	THEN file a return if your gross income** was at least . . .
Single	under 65 65 or older	$7,450 8,550
Married filing jointly***	under 65 (both spouses) 65 or older (one spouse) 65 or older (both spouses)	$13,400 14,300 15,200
Married filing separately	any age	$2,900
Head of household (see page 19)	under 65 65 or older	$9,550 10,650
Qualifying widow(er) with dependent child (see page 19)	under 65 65 or older	$10,500 11,400

** If you turned 65 on January 1, 2002, you are considered to be age 65 at the end of 2001.*

*** **Gross income** means all income you received in the form of money, goods, property, and services that is not exempt from tax including any income from sources outside the United States (even if you may exclude part or all of it). **Do not** include social security benefits unless you are married filing a separate return and you lived with your spouse at any time in 2001.*

**** If you did not live with your spouse at the end of 2001 (or on the date your spouse died) and your gross income was at least $2,900, you must file a return regardless of your age.*

Chart B—For Children and Other Dependents (See the instructions for line 6c on page 20 to find out if someone can claim you as a dependent.)

If your parent (or someone else) can claim you as a dependent, use this chart to see if you must file a return.

In this chart, **unearned income** includes taxable interest, ordinary dividends, and capital gain distributions. **Earned income** includes wages, tips, and taxable scholarship and fellowship grants. **Gross income** is the total of your unearned and earned income.

If your gross income was $2,900 or more, you usually cannot be claimed as a dependent unless you were under age 19 **or** a student under age 24. For details, see **Pub. 501.**

Single dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply.
- Your **unearned income** was over $750.
- Your **earned income** was over $4,550.
- Your **gross income** was more than the **larger** of—
  - $750 **or**
  - Your earned income (up to $4,300) plus $250.

☐ **Yes.** You must file a return if **any** of the following apply.
- Your unearned income was over $1,850 ($2,950 if 65 or older **and** blind).
- Your earned income was over $5,650 ($6,750 if 65 or older **and** blind).
- Your gross income was more than—

The larger of:	Plus	This amount:
• $750 **or** • Your earned income (up to $4,300) plus $250	}	$1,100 ($2,200 if 65 or older **and** blind)

Married dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply.
- Your unearned income was over $750.
- Your earned income was over $3,800.
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than the **larger** of—
  - $750 **or**
  - Your earned income (up to $3,550) plus $250.

☐ **Yes.** You must file a return if **any** of the following apply.
- Your unearned income was over $1,650 ($2,550 if 65 or older **and** blind).
- Your earned income was over $4,700 ($5,600 if 65 or older **and** blind).
- Your gross income was at least $5 and your spouse files a separate return and itemizes deductions.
- Your gross income was more than—

The larger of:	Plus	This amount:
• $750 **or** • Your earned income (up to $3,550) plus $250	}	$900 ($1,800 if 65 or older **and** blind)

Chart C—Other Situations When You Must File

You must file a return if any of the four conditions below apply for 2001.

1. You owe any special taxes, such as:
- Social security and Medicare tax on tips you did not report to your employer,
- Uncollected social security and Medicare or RRTA tax on tips you reported to your employer or on group-term life insurance,
- Alternative minimum tax,
- Recapture taxes (see the instructions for lines 40 and 58 that begin on pages 33 and 39), or
- Tax on a qualified plan, including an individual retirement arrangement (IRA), or other tax-favored account. But if you are filing a return only because you owe this tax, you can file **Form 5329** by itself.

2. You received any advance earned income credit (EIC) payments from your employer. These payments are shown in box 9 of your W-2 form.

3. You had net earnings from self-employment of at least $400.

4. You had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.

Where To Report Certain Items From 2001 Forms W-2, 1098, and 1099

Report on Form 1040, line 59, any amounts shown on these forms as **Federal income tax withheld.** If you itemize your deductions, report on Schedule A, line 5, any amounts shown on these forms as **state or local income tax withheld.**

Form	Item and Box in Which it Should Appear	Where To Report if Filing Form 1040
W-2	Wages, salaries, tips, etc. (box 1)	Form 1040, line 7
	Allocated tips (box 8)	See **Tip income** on page 21
	Advance EIC payment (box 9)	Form 1040, line 56
	Dependent care benefits (box 10)	Form 2441, line 10
	Adoption benefits (box 12, code **T**)	Form 8839, line 18
	Employer contributions to an MSA (box 12, code **R**)*	Form 8853, line 3b
W-2G	Gambling winnings (box 1)	Form 1040, line 21 (Schedule C or C-EZ for professional gamblers)
1098	Mortgage interest (box 1) Points (box 2)	Schedule A, line 10**
	Refund of overpaid interest (box 3)	Form 1040, line 21, but first see the instructions on Form 1098**
1098-E	Student loan interest (box 1)	See the instructions for Form 1040, line 24, that begin on page 28**
1099-A	Acquisition or abandonment of secured property	See Pub. 544
1099-B	Stocks, bonds, etc. (box 2)	Schedule D
	Bartering (box 3)	See Pub. 525
	Aggregate profit or (loss) on futures contracts (box 9)	Form 6781
1099-C	Canceled debt (box 2)	Form 1040, line 21, but first see the instructions on Form 1099-C**
1099-DIV	Ordinary dividends (box 1)	Form 1040, line 9
	Total capital gain distributions (box 2a)	Form 1040, line 13, or, if required, Schedule D, line 13, column (f)
	28% rate gain (box 2b)	Schedule D, line 13, column (g)
	Qualified 5-year gain (box 2c)	See the worksheet for Schedule D, line 29, on page D-8
	Unrecaptured section 1250 gain (box 2d)	See the worksheet for Schedule D, line 19, on page D-7
	Section 1202 gain (box 2e)	See the instructions for Schedule D
	Nontaxable distributions (box 3)	See the instructions for Form 1040, line 9, that begin on page 21
	Investment expenses (box 5)	Schedule A, line 22
	Foreign tax paid (box 6)	Form 1040, line 43, or Schedule A, line 8
1099-G	Unemployment compensation (box 1)	Form 1040, line 19. But if you repaid any unemployment compensation in 2001, see the instructions for line 19 on page 25
	State or local income tax refunds (box 2)	See the instructions for Form 1040, line 10, that begin on page 22**
	Qualified state tuition program earnings (box 5)	Form 1040, line 21
	Taxable grants (box 6)	Form 1040, line 21**
	Agriculture payments (box 7)	See the Schedule F instructions or Pub. 225

* *MSAs were renamed Archer MSAs after Form W-2 was released for print.*

** *If the item relates to an activity for which you are required to file Schedule C, C-EZ, E, or F or Form 4835, report the taxable or deductible amount allocable to the activity on that schedule or form instead.*

(Continued on page 18)

Form	Item and Box in Which it Should Appear	Where To Report if Filing Form 1040
1099-INT	Interest income (box 1)	Form 1040, line 8a
	Early withdrawal penalty (box 2)	Form 1040, line 30
	Interest on U.S. savings bonds and Treasury obligations (box 3)	See the instructions for Form 1040, line 8a, on page 21
	Investment expenses (box 5)	Schedule A, line 22
	Foreign tax paid (box 6)	Form 1040, line 43, or Schedule A, line 8
1099-LTC	Long-term care and accelerated death benefits	See Pub. 502 and the instructions for Form 8853
1099-MISC	Rents (box 1)	See the instructions for Schedule E
	Royalties (box 2)	Schedule E, line 4 (timber, coal, iron ore royalties, see Pub. 544)
	Other income (box 3)	Form 1040, line 21*
	Nonemployee compensation (box 7)	Schedule C, C-EZ, or F. But if you were not self-employed, see the instructions on Form 1099-MISC.
	Other (boxes 5, 6, 8, 9, 10, 13, and 14)	See the instructions on Form 1099-MISC
1099-MSA	Distributions from MSAs**	Form 8853
1099-OID	Original issue discount (box 1) Other periodic interest (box 2)	See the instructions on Form 1099-OID
	Early withdrawal penalty (box 3)	Form 1040, line 30
1099-PATR	Patronage dividends and other distributions from a cooperative (boxes 1, 2, 3, and 5)	Schedule C, C-EZ, or F or Form 4835, but first see the instructions on Form 1099-PATR
	Credits (boxes 7 and 8)	Form 3468 or Form 5884
	Patron's AMT adjustment (box 9)	Form 6251, line 14j
1099-R	Distributions from IRAs***	See the instructions for Form 1040, lines 15a and 15b, on page 23
	Distributions from pensions, annuities, etc.	See the instructions for Form 1040, lines 16a and 16b, that begin on page 23
	Capital gain (box 3)	See the instructions on Form 1099-R
1099-S	Gross proceeds from real estate transactions (box 2)	Form 4797, Form 6252, or Schedule D. But if the property was your home, see the instructions for Schedule D to find out if you must report the sale or exchange.
	Buyer's part of real estate tax (box 5)	See the instructions for Schedule A, line 6, on page A-2*

* *If the item relates to an activity for which you are required to file Schedule C, C-EZ, E, or F or Form 4835, report the taxable or deductible amount allocable to the activity on that schedule or form instead.*

** *This includes distributions from Archer and Medicare+Choice MSAs.*

*** *This includes distributions from Roth, SEP, and SIMPLE IRAs; and Coverdell education savings accounts (ESAs).*

Private Delivery Services

You can use certain private delivery services designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. The most recent list of designated private delivery services was published by the IRS in October 2001. The list includes only the following:

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service.
- DHL Worldwide Express (DHL): DHL "Same Day" Service, and DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.

Line Instructions for Form 1040

Name and Address

Use the Peel-Off Label

Using your peel-off name and address label in this booklet will speed the processing of your return. It also prevents common errors that can delay refunds or result in unnecessary notices. Put the label on your return **after** you have finished it. Cross out any errors and print the correct information. Add any missing items, such as your apartment number.

Address Change

If the address on your peel-off label is not your current address, cross out your old address and print your new address. If you plan to move after filing your return, see page 54.

Name Change

If you changed your name, be sure to report the change to your local Social Security Administration office **before** filing your return. This prevents delays in processing your return and issuing refunds. It also safeguards your future social security benefits. See page 54 for more details. If you received a peel-off label, cross out your former name and print your new name.

What If You Do Not Have a Label?

Print or type the information in the spaces provided. If you are married filing a separate return, enter your husband's or wife's name on line 3 instead of below your name.

If you filed a joint return for 2000 and you are filing a joint return for 2001 with the same spouse, be sure to enter your names and SSNs in the same order as on your 2000 return.

P.O. Box

Enter your box number **only** if your post office does not deliver mail to your home.

Foreign Address

Enter the information in the following order: City, province or state, and country. Follow the country's practice for entering the postal code. **Do not** abbreviate the country name.

Death of a Taxpayer

See page 55.

Social Security Number (SSN)

An incorrect or missing SSN may increase your tax or reduce your refund. **To apply for an SSN,** get **Form SS-5** from your local Social Security Administration (SSA) office or call the SSA at 1-800-772-1213. Fill in Form SS-5 and return it to the SSA. It usually takes about 2 weeks to get an SSN.

Check that your SSN is correct on your Forms W-2 and 1099. If not, see page 54 for more details.

IRS Individual Taxpayer Identification Numbers (ITINs) for Aliens

The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. **To apply for an ITIN,** file **Form W-7** with the IRS. It usually takes about 4-6 weeks to get an ITIN. **Enter your ITIN wherever your SSN is requested on your tax return.**

Note. An ITIN is for tax use only. It does not entitle you to social security benefits or change your employment or immigration status under U.S. law.

Nonresident Alien Spouse

If your spouse is a nonresident alien and you file a joint or separate return, your spouse must have either an SSN or an ITIN.

Presidential Election Campaign Fund

This fund helps pay for Presidential election campaigns. The fund reduces candidates' dependence on large contributions from individuals and groups and places candidates on an equal financial footing in the general election. If you want $3 to go to this fund, check the "Yes" box. If you are filing a joint return, your spouse may also have $3 go to the fund. If you check "Yes," your tax or refund will not change.

Filing Status

Check **only** the filing status that applies to you. The ones that will usually give you the lowest tax are listed last.

- Married filing separately.
- Single.
- **Head of household.** This status is for unmarried people who paid over half the cost of keeping up a home for a qualifying person, such as a child who lived with you or your dependent parent. Certain married people who lived apart from their spouse for the last 6 months of 2001 may also be able to use this status.
- Married filing jointly or Qualifying widow(er) with dependent child. The **Qualifying widow(er)** status is for certain people whose spouse died in 1999 or 2000 and who had a child living with them whom they can claim as a dependent.

Joint and Several Tax Liability. If you file a joint return, both you and your spouse are generally responsible for the tax and any interest or penalties due on the return. This means that if one spouse does not pay the tax due, the other may have to. However, see **Innocent Spouse Relief** on page 54.

More than one filing status may apply to you. Choose the one that will give you the lowest tax. If you are not sure about your filing status, use TeleTax topic 353 (see page 11) or see **Pub. 501.**

Exemptions

You usually can deduct $2,900 on line 38 for each exemption you can take.

Line 6b

Spouse

Check the box on line 6b if you file either **(a)** a joint return or **(b)** a separate return and your spouse had no income and is not filing a return. However, **do not** check the box if your spouse can be claimed as a dependent on another person's return.

Need more information or forms? See page 7.

Line 6c

Dependents

You can take an exemption for each of your dependents. The following is a brief description of the five tests that must be met for a person to qualify as your dependent. If you have **more than six** dependents, attach a statement to your return with the required information.

Relationship Test. The person must be either your relative or have lived in your home as a family member all year. If the person is not your relative, the relationship must not violate local law.

Joint Return Test. If the person is married, he or she cannot file a joint return. But the person can file a joint return if the return is filed only as a claim for refund **and** no tax liability would exist for either spouse if they had filed separate returns.

Citizen or Resident Test. The person must be a U.S. citizen or resident alien, or a resident of Canada or Mexico. There is an exception for certain adopted children. To find out who is a **resident alien,** use TeleTax topic 851 (see page 11) or see **Pub. 519.**

Income Test. The person's gross income must be less than $2,900. But your child's gross income can be $2,900 or more if he or she was either **(a) under age 19** at the end of 2001 or **(b) under age 24** at the end of 2001 and was a **student.**

Support Test. You must have provided over half of the person's total support in 2001. But there are two exceptions to this test: One for children of divorced or separated parents and one for persons supported by two or more taxpayers.

TIP For more details about the tests, including any exceptions that apply, see **Pub. 501.**

Line 6c, Column (2)

You must enter each dependent's social security number (SSN). Be sure the name and SSN entered agree with the dependent's social security card. Otherwise, at the time we process your return, we may disallow the exemption claimed for the dependent and reduce or disallow any other tax benefits (such as the child tax credit and the earned income credit) based on that dependent. If the name or SSN on the dependent's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

TIP For details on how your dependent can get an SSN, see page 19. If your dependent will not have a number by April 15, 2002, see **What if You Cannot File on Time?** on page 15.

If your dependent child was born and died in 2001 and you do not have an SSN for the child, you may attach a copy of the child's birth certificate instead and enter "Died" in column (2).

Adoption Taxpayer Identification Numbers (ATINs). If you have a dependent who was placed with you by an authorized placement agency and you do not know his or her SSN, you must get an ATIN for the dependent from the IRS. An authorized placement agency includes any person authorized by state law to place children for legal adoption. See **Form W-7A** for details.

Line 6c, Column (4)

Check the box in this column if your dependent is a qualifying child for the child tax credit (defined below). If you have at least one qualifying child, you may be able to take the child tax credit on line 48 and the additional child tax credit on line 63.

Qualifying Child for Child Tax Credit. A qualifying child for purposes of the child tax credit is a child who:

- Is claimed as your dependent on line 6c, **and**
- Was **under age 17** at the end of 2001, **and**
- Is your son, daughter, adopted child, grandchild, stepchild, or foster child, **and**
- Is a U.S. citizen or resident alien.

Note. The above requirements are not the same as the requirements to be a qualifying child for the earned income credit.

A child placed with you by an authorized placement agency for legal adoption is an **adopted child** even if the adoption is not final. An authorized placement agency includes any person authorized by state law to place children for legal adoption.

A **grandchild** is any descendant of your son, daughter, or adopted child and includes your great-grandchild, great-great-grandchild, etc.

A **foster child** is any child you cared for as your own child and who:

- Is **(a)** your brother, sister, stepbrother, or stepsister; **(b)** a descendant (such as a child, including an adopted child) of your brother, sister, stepbrother, or stepsister; **or (c)** a child placed with you by an authorized placement agency **and**
- Lived with you for all of 2001. A child who was born or died in 2001 is considered to have lived with you for all of 2001 if your home was the child's home for the entire time he or she was alive during 2001.

Children Who Did Not Live With You Due to Divorce or Separation

If you are claiming a child who did not live with you under the rules explained in **Pub. 501** for children of divorced or separated parents, attach **Form 8332** or similar statement to your return. But see **Exception** below. If your divorce decree or separation agreement went into effect after 1984 and it states you can claim the child as your dependent without regard to any condition, such as payment of support, you may attach a copy of the following pages from the decree or agreement instead.

- Cover page (put the other parent's SSN on that page),
- The page that states you can claim the child as your dependent, and
- Signature page with the other parent's signature and date of agreement.

Note. You must attach the required information even if you filed it in an earlier year.

Exception. You do not have to attach Form 8332 or similar statement if your divorce decree or written separation agreement went into effect before 1985 and it states that you can claim the child as your dependent.

Other Dependent Children

Include the total number of children who did not live with you for reasons other than divorce or separation on the line labeled "Dependents on 6c not entered above." Include dependent children who lived in Canada or Mexico during 2001.

Income

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** and **Form 2555** or **2555-EZ.**

Community Property States

Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. If you and your spouse lived in a community property state, you must usually follow state law to determine what is community income and what is separate income. For details, see **Pub. 555.**

Rounding Off to Whole Dollars

To round off cents to the nearest whole dollar on your forms and schedules, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. If you do round off, do so for all amounts. But if you have to add two or more amounts to figure the amount to enter on a line, include cents when adding and only round off the total.

Line 7

Wages, Salaries, Tips, etc.

Enter the total of your wages, salaries, tips, etc. If a joint return, also include your spouse's income. For most people, the amount to enter on this line should be shown in box 1 of their **Form(s) W-2.** But the following types of income must also be included in the total on line 7.

- Wages received as a **household employee** for which you did not receive a W-2 form because your employer paid you less than $1,300 in 2001. Also, enter "HSH" and the amount not reported on a W-2 form on the dotted line next to line 7.
- **Tip income** you did not report to your employer. Also include **allocated tips** shown on your W-2 form(s) unless you can prove that you received less. Allocated tips should be shown in box 8 of your W-2 form(s). They are not included as income in box 1. See **Pub. 531** for more details.

CAUTION You may owe social security and Medicare tax on unreported or allocated tips. See the instructions for line 54 on page 39.

- **Dependent care benefits,** which should be shown in box 10 of your W-2 form(s). But first complete **Form 2441** to see if you may exclude part or all of the benefits.
- **Employer-provided adoption benefits,** which should be shown in box 12 of your W-2 form(s) with code **T.** But first complete **Form 8839** to see if you may exclude part or all of the benefits.
- **Scholarship and fellowship grants** not reported on a W-2 form. Also, enter "SCH" and the amount on the dotted line next to line 7. **Exception.** If you were a degree candidate, include on line 7 **only** the amounts you used for expenses other than tuition and course-related expenses. For example, amounts used for room, board, and travel must be reported on line 7.
- **Excess salary deferrals.** The amount deferred should be shown in box 12 of your W-2 form and the "Retirement plan" box in box 13 should be checked. If the total amount you (or your spouse if filing jointly) deferred for 2001 under **all** plans was more than $10,500, include the excess on line 7. But a different limit may apply if amounts were deferred under a tax-sheltered annuity plan or an eligible plan of a state or local government or tax-exempt organization. See **Pub. 525** for details.

CAUTION You may **not** deduct the amount deferred. It is not included as income in box 1 of your W-2 form.

- **Disability pensions** shown on **Form 1099-R** if you have not reached the minimum retirement age set by your employer. Disability pensions received after you reach that age and other pensions shown on Form 1099-R (other than payments from an IRA* or a Coverdell education savings account (ESA)) are reported on lines 16a and 16b. Payments from an IRA or a Coverdell ESA are reported on lines 15a and 15b.
- **Corrective distributions** shown on **Form 1099-R** of **(a)** excess salary deferrals plus earnings and **(b)** excess contributions plus earnings to a retirement plan. But do not include distributions from an IRA* or a Coverdell ESA on line 7. Instead, report them on lines 15a and 15b.

**This includes a Roth, SEP, or SIMPLE IRA.*

Were You a Statutory Employee?

If you were, the "Statutory employee" box in box 13 of your W-2 form should be checked. Statutory employees include full-time life insurance salespeople, certain agent or commission drivers and traveling salespeople, and certain homeworkers. If you have related business expenses to deduct, report the amount shown in box 1 of your W-2 form on **Schedule C** or **C-EZ** along with your expenses.

Missing or Incorrect Form W-2?

If you do not get a W-2 form from your employer by January 31, 2002, use TeleTax topic 154 (see page 11) to find out what to do. Even if you do not get a Form W-2, you must still report your earnings on line 7. If you lose your Form W-2 or it is incorrect, ask your employer for a new one.

Line 8a

Taxable Interest

Each payer should send you a **Form 1099-INT** or **Form 1099-OID.** Enter your total taxable interest income on line 8a. But you must fill in and attach **Schedule B** if the total is over $400 or any of the other conditions listed at the beginning of the Schedule B instructions (see page B-1) apply to you.

Interest credited in 2001 on deposits that you could not withdraw because of the bankruptcy or insolvency of the financial institution may not have to be included in your 2001 income. For details, see **Pub. 550.**

TIP If you get a 2001 Form 1099-INT for U.S. savings bond interest that includes amounts you reported before 2001, see Pub. 550.

Line 8b

Tax-Exempt Interest

If you received any tax-exempt interest, such as from municipal bonds, report it on line 8b. Include any exempt-interest dividends from a mutual fund or other regulated investment company. **Do not** include interest earned on your IRA or Coverdell education savings account.

Line 9

Ordinary Dividends

Each payer should send you a **Form 1099-DIV.** Enter your total ordinary dividends on line 9. But you must fill in and attach **Schedule B** if the total is over $400 or you received, as a nominee, ordinary dividends that actually belong to someone else.

Capital Gain Distributions

If you received any capital gain distributions, see the instructions for line 13 on page 23.

(Continued on page 22)

Need more information or forms? See page 7.

Nontaxable Distributions

Some distributions are nontaxable because they are a return of your cost (or other basis). They will not be taxed until you recover your cost (or other basis). You must reduce your cost (or other basis) by these distributions. After you get back all of your cost (or other basis), you must report these distributions as capital gains on **Schedule D.** For details, see **Pub. 550.**

TIP Dividends on insurance policies are a partial return of the premiums you paid. **Do not** report them as dividends. Include them in income only if they exceed the total of all net premiums you paid for the contract.

Line 10

Taxable Refunds, Credits, or Offsets of State and Local Income Taxes

TIP None of your refund is taxable if, in the year you paid the tax, you **did not** itemize deductions.

If you received a refund, credit, or offset of state or local income taxes in 2001, you may receive a **Form 1099-G.** If you chose to apply part or all of the refund to your 2001 estimated state or local income tax, the amount applied is treated as received in 2001. If the refund was for a tax you paid in 2000 and you itemized deductions for 2000, use the worksheet below to see if any of your refund is taxable.

Exception. See **Recoveries** in **Pub. 525** instead of using the worksheet below if **any** of the following apply.

- You received a refund in 2001 that is for a tax year other than 2000.
- You received a refund other than an income tax refund, such as a real property tax refund, in 2001 of an amount deducted or credit claimed in an earlier year.
- Your 2000 taxable income was less than zero.
- You made your last payment of 2000 estimated state or local income tax in 2001.
- You owed alternative minimum tax in 2000.
- You could not deduct the full amount of credits you were entitled to in 2000 because the total credits exceeded the amount shown on your 2000 Form 1040, line 42, minus any foreign tax credit shown on line 43 of that form.
- You could be claimed as a dependent by someone else in 2000.

Also, see **Tax Benefit Rule** in Pub. 525 instead of using the worksheet below if **all three** of the following apply.

1. You had to use the Itemized Deductions Worksheet in the 2000 Schedule A instructions because your 2000 adjusted gross income was over: $128,950 if single, married filing jointly, head of household, or qualifying widow(er); $64,475 if married filing separately.

(Continued on page 23)

State and Local Income Tax Refund Worksheet—Line 10

Keep for Your Records

1. Enter the income tax refund from **Form(s) 1099-G** (or similar statement). But **do not** enter more than the amount on your 2000 Schedule A (Form 1040), line 5 . . . . . **1.** _____

2. Enter your total allowable itemized deductions from your 2000 Schedule A (Form 1040), line 28 . . . . . **2.** _____

Note. If the filing status on your 2000 Form 1040 was married filing separately and your spouse itemized deductions in 2000, skip lines 3, 4, and 5, and enter the amount from line 2 on line 6.

3. Enter the amount shown below for the filing status claimed on your **2000** Form 1040.
- Single—$4,400
- Married filing jointly or qualifying widow(er)—$7,350
- Married filing separately—$3,675
- Head of household—$6,450

. . . **3.** _____

4. Did you fill in line 35a on your 2000 Form 1040?

☐ **No.** Enter -0-.

☐ **Yes.** Multiply the number on line 35a of your 2000 Form 1040 by: $850 if your 2000 filing status was married filing jointly or separately or qualifying widow(er); $1,100 if your 2000 filing status was single or head of household **4.** _____

5. Add lines 3 and 4 . . . . . **5.** _____

6. Is the amount on line 5 less than the amount on line 2?

☐ **No.** STOP None of your refund is taxable.

☐ **Yes.** Subtract line 5 from line 2 . . . . . **6.** _____

7. Taxable part of your refund. Enter the **smaller** of line 1 or line 6 here and on Form 1040, line 10 . . . . . **7.** _____

2. You could not deduct all of the amount on line 1 of the 2000 Itemized Deductions Worksheet.

3. The amount on line 8 of that 2000 worksheet would be more than the amount on line 4 of that worksheet if the amount on line 4 were reduced by 80% of the refund you received in 2001.

Line 11

Alimony Received

Enter amounts received as alimony or separate maintenance. You must let the person who made the payments know your social security number. If you do not, you may have to pay a $50 penalty. For more details, use TeleTax topic 406 (see page 11) or see **Pub. 504.**

Line 12

Business Income or (Loss)

If you operated a business or practiced your profession as a sole proprietor, report your income and expenses on **Schedule C** or **C-EZ.**

Line 13

Capital Gain or (Loss)

If you had a capital gain or loss, including any **capital gain distributions** from a mutual fund, you **must** complete and attach **Schedule D.**

Exception. You do not have to file Schedule D if **all three** of the following apply.

1. The only amounts you have to report on Schedule D are capital gain distributions from box 2a of **Forms 1099-DIV** or substitute statements.

2. None of the Forms 1099-DIV or substitute statements have an amount in box 2b (28% rate gain), box 2c (qualified 5-year gain), box 2d (unrecaptured section 1250 gain), or box 2e (section 1202 gain).

3. You are not filing **Form 4952** (relating to investment interest expense deduction) **or** the amount on line 4e of that form is zero or blank.

If all three of the above apply, enter your capital gain distributions on line 13 and check the box on that line. Also, be sure you use the **Capital Gain Tax Worksheet** on page 34 to figure your tax.

Line 14

Other Gains or (Losses)

If you sold or exchanged assets used in a trade or business, see the Instructions for **Form 4797.**

Lines 15a and 15b

IRA Distributions

Note. If you converted part or all of an individual retirement arrangement (IRA) to a Roth IRA in 1998 and you chose to report the taxable amount over 4 years, see **1998 Roth IRA Conversions** on this page.

You should receive a **Form 1099-R** showing the amount of any distribution from your IRA or Coverdell education savings account (ESA). Unless otherwise noted in the line 15a and 15b instructions, an IRA includes a traditional IRA, Roth IRA, simplified employee pension (SEP) IRA, and a savings incentive match plan for employees (SIMPLE) IRA. Except as provided below, leave line 15a blank and enter the total distribution on line 15b.

Exception 1. Enter the total distribution on line 15a if you rolled over part or all of the distribution from one:

- IRA to another IRA of the same type (for example, from one traditional IRA to another traditional IRA),
- Coverdell ESA to another, or
- SEP or SIMPLE IRA to a traditional IRA.

Also, put "Rollover" next to line 15b. If the total distribution was rolled over, enter zero on line 15b. If the total was not rolled over, enter the part not rolled over on line 15b unless **Exception 2** applies to the part not rolled over.

If you rolled over the distribution **(a)** in 2002 or **(b)** from a conduit IRA into a qualified plan, attach a statement explaining what you did.

Exception 2. If **any** of the following apply, enter the total distribution on line 15a and use **Form 8606** and its instructions to figure the amount to enter on line 15b.

- You received a distribution from an IRA (other than a Roth IRA) and you made nondeductible contributions to any of your traditional or SEP IRAs for 2001 or an earlier year. If you made nondeductible contibutions to these IRAs for 2001, also see **Pub. 590.**
- You received a distribution from a Roth IRA or Coverdell ESA.
- You converted part or all of a traditional, SEP, or SIMPLE IRA to a Roth IRA in 2001.
- You had a 2000 or 2001 IRA or Coverdell ESA contribution returned to you, with the related earnings or less any loss, by the due date (including extensions) of your tax return for that year.
- You made excess contributions to your IRA for an earlier year and had them returned to you in 2001.
- You recharacterized part or all of a contribution to a Roth IRA as a traditional IRA contribution, or vice versa.

Note. If you received more than one distribution, figure the taxable amount of each distribution and enter the total of the taxable amounts on line 15b. Enter the total amount of those distributions on line 15a.

You may have to pay an additional tax if **(a)** you received an early distribution from your IRA and the total was not rolled over or **(b)** you were born before July 1, 1930, and received less than the minimum required distribution from your traditional, SEP, and SIMPLE IRAs. See the instructions for line 55 on page 39 for details.

1998 Roth IRA Conversions. If you converted an IRA to a Roth IRA in 1998 and you chose to report the taxable amount over 4 years, leave line 15a blank and enter on line 15b the amount from your **1998 Form 8606,** line 17. **But** see the 2001 Instructions for Form 8606 for the amount to enter on line 15b if **(a)** you rounded the amount on line 17 of your 1998 Form 8606 to the next higher whole dollar or **(b)** you received a distribution from a Roth IRA in 1998, 1999, or 2000.

Lines 16a and 16b

Pensions and Annuities

You should receive a **Form 1099-R** showing the amount of your pension and annuity payments. See page 25 for details on rollovers and lump-sum distributions. **Do not** include the following payments on lines 16a and 16b. Instead, report them on line 7.

- Disability pensions received before you reach the minimum retirement age set by your employer.
- Corrective distributions of excess salary deferrals or excess contributions to retirement plans.

(Continued on page 24)

Need more information or forms? See page 7.

TIP Attach Form(s) 1099-R to Form 1040 if any Federal income tax was withheld.

Fully Taxable Pensions and Annuities

If your pension or annuity is fully taxable, enter it on line 16b; **do not** make an entry on line 16a. Your payments are fully taxable if **either** of the following applies.

- You did not contribute to the cost (see page 25) of your pension or annuity **or**
- You got your entire cost back tax free before 2001.

Fully taxable pensions and annuities also include military retirement pay shown on Form 1099-R. For details on military disability pensions, see **Pub. 525.** If you received a **Form RRB-1099-R,** see **Pub. 575** to find out how to report your benefits.

Partially Taxable Pensions and Annuities

Enter the total pension or annuity payments you received in 2001 on line 16a. If your Form 1099-R does not show the taxable amount, you must use the General Rule explained in **Pub. 939** to figure the taxable part to enter on line 16b. But if your annuity starting date (defined on page 25) was **after** July 1, 1986, see page 25 to find out if you must use the Simplified Method to figure the taxable part.

You can ask the IRS to figure the taxable part for you for an $85 fee. For details, see Pub. 939.

(Continued on page 25)

Simplified Method Worksheet—Lines 16a and 16b

Keep for Your Records

Before you begin: √ If you are the beneficiary of a deceased employee or former employee who died **before** August 21, 1996, see Pub. 939 to find out if you are entitled to a death benefit exclusion of up to $5,000. If you are, include the exclusion in the amount entered on line 2 below.

Note. If you had more than one partially taxable pension or annuity, figure the taxable part of each separately. Enter the total of the taxable parts on Form 1040, line 16b. Enter the total pension or annuity payments received in 2001 on Form 1040, line 16a.

1.	Enter the total pension or annuity payments received in 2001. Also, enter this amount on Form 1040, line 16a		**1.** _____
2.	Enter your cost in the plan at the annuity starting date	**2.** _____	
3.	Enter the appropriate number from **Table 1** below. **But** if your annuity starting date was **after** 1997 **and** the payments are for your life and that of your beneficiary, enter the appropriate number from **Table 2** below	**3.** _____	
4.	Divide line 2 by the number on line 3	**4.** _____	
5.	Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was **before** 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6	**5.** _____	
6.	Enter the amount, if any, recovered tax free in years after 1986	**6.** _____	
7.	Subtract line 6 from line 2	**7.** _____	
8.	Enter the **smaller** of line 5 or line 7		**8.** _____
9.	**Taxable amount.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R		**9.** _____

Table 1 for Line 3 Above

	AND your annuity starting date was—	
IF the age at annuity starting date (see page 25) was . . .	**before** November 19, 1996, enter on line 3 . . .	**after** November 18, 1996, enter on line 3 . . .
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2 for Line 3 Above

IF the combined ages at annuity starting date (see page 25) were . . .	THEN enter on line 3 . . .
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

If your Form 1099-R shows a taxable amount, you may report that amount on line 16b. But you may be able to report a lower taxable amount by using the General Rule or the Simplified Method.

Annuity Starting Date

Your annuity starting date is the later of the first day of the first period for which you received a payment, or the date the plan's obligations became fixed.

Simplified Method

You **must** use the Simplified Method if **(a)** your annuity starting date (defined above) was **after** July 1, 1986, and you used this method last year to figure the taxable part or **(b)** your annuity starting date was **after** November 18, 1996, and **all three** of the following apply.

1. The payments are for **(a)** your life or **(b)** your life and that of your beneficiary.

2. The payments are from a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity.

3. On your annuity starting date, either you were under age 75 or the number of years of guaranteed payments was fewer than 5. See Pub. 575 for the definition of guaranteed payments.

If you must use the Simplified Method, complete the worksheet on page 24 to figure the taxable part of your pension or annuity. For more details on the Simplified Method, see Pub. 575 or **Pub. 721** for U.S. Civil Service retirement.

If you received U.S. Civil Service retirement benefits and you chose the alternative annuity option, use the worksheet in Pub. 721. **Do not** use the worksheet on page 24.

Age (or Combined Ages) at Annuity Starting Date

If you are the retiree, use your age on the annuity starting date. If you are the survivor of a retiree, use the retiree's age on his or her annuity starting date. **But** if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, use your combined ages on the annuity starting date.

If you are the beneficiary of an employee who died, see Pub. 575. If there is more than one beneficiary, see Pub. 575 or Pub. 721 to figure each beneficiary's taxable amount.

Cost

Your cost is generally your net investment in the plan as of the annuity starting date. It does not include pre-tax contributions. Your net investment should be shown in box 9b of Form 1099-R for the first year you received payments from the plan.

Rollovers

A rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another plan. Use lines 16a and 16b to report a rollover, including a direct rollover, from one qualified employer's plan to another or to an IRA or SEP.

Enter on line 16a the total distribution before income tax or other deductions were withheld. This amount should be shown in box 1 of **Form 1099-R.** From the total on line 16a, subtract any contributions (usually shown in box 5) that were taxable to you when made. From that result, subtract the amount that was rolled over either directly or within 60 days of receiving the distribution. Enter the remaining amount, even if zero, on line 16b. Also, put "Rollover" next to line 16b.

Special rules apply to partial rollovers of property. For more details on rollovers, including distributions under qualified domestic relations orders, see Pub. 575.

Lump-Sum Distributions

If you received a lump-sum distribution from a profit-sharing or retirement plan, your Form 1099-R should have the "Total distribution" box in box 2b checked. You may owe an additional tax if you received an early distribution from a qualified retirement plan and the total amount was not rolled over. For details, see the instructions for line 55 on page 39.

Enter the total distribution on line 16a and the taxable part on line 16b.

You may be able to pay less tax on the distribution if you were born before 1936, you meet certain other conditions, and you choose to use **Form 4972** to figure the tax on any part of the distribution. You may also be able to use Form 4972 if you are the beneficiary of a deceased employee who was born before 1936. For details, see Form 4972.

Line 19

Unemployment Compensation

You should receive a **Form 1099-G** showing the total unemployment compensation paid to you in 2001.

If you received an overpayment of unemployment compensation in 2001 and you repaid any of it in 2001, subtract the amount you repaid from the total amount you received. Enter the result on line 19. Also, enter "Repaid" and the amount you repaid on the dotted line next to line 19. If, in 2001, you repaid unemployment compensation that you included in gross income in an earlier year, you may deduct the amount repaid on **Schedule A,** line 22. But if you repaid more than $3,000, see **Repayments** in **Pub. 525** for details on how to report the repayment.

Lines 20a and 20b

Social Security Benefits

You should receive a **Form SSA-1099** showing in box 3 the total social security benefits paid to you. Box 4 will show the amount of any benefits you repaid in 2001. If you received railroad retirement benefits treated as social security, you should receive a **Form RRB-1099.**

Use the worksheet on page 26 to see if any of your benefits are taxable.

Exception. Do not use the worksheet on page 26 if **any** of the following apply.

- You made contributions to a traditional IRA for 2001 and you were covered by a retirement plan at work or through self-employment. Instead, use the worksheets in **Pub. 590** to see if any of your social security benefits are taxable and to figure your IRA deduction.
- You repaid any benefits in 2001 and your total repayments (box 4) were more than your total benefits for 2001 (box 3). **None** of your benefits are taxable for 2001. In addition, you may be able to take an itemized deduction for part of the excess repayments if they were for benefits you included in gross income in an earlier year. For more details, see **Pub. 915.**
- You file **Form 2555, 2555-EZ, 4563,** or **8815,** or you exclude employer-provided adoption benefits or income from sources within Puerto Rico. Instead, use the worksheet in Pub. 915.

Need more information or forms? See page 7.

Social Security Benefits Worksheet—Lines 20a and 20b

Keep for Your Records

Before you begin:

- √ Complete Form 1040, lines 21, 23, and 25 through 31a, if they apply to you.
- √ Figure any amount to be entered on the dotted line next to line 32 (see page 30).
- √ If you are married filing separately and you **lived apart** from your spouse for all of 2001, enter "D" to the right of the word "benefits" on line 20a.
- √ Be sure you have read the **Exception** on page 25 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1. Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **RRB-1099** . . . . . **1.** _____

2. Is the amount on line 1 more than zero?

☐ **No.** STOP None of your social security benefits are taxable.

☐ **Yes.** Enter one-half of line 1 . . . . . **2.** _____

3. Add the amounts on Form 1040, lines 7, 8a, 9 through 14, 15b, 16b, 17 through 19, and 21. Do not include amounts from box 5 of Forms SSA-1099 or RRB-1099 . . . . . **3.** _____

4. Enter the amount, if any, from Form 1040, line 8b . . . . . **4.** _____

5. Add lines 2, 3, and 4 . . . . . **5.** _____

6. Add the amounts on Form 1040, lines 23, and 25 through 31a, and any amount you entered on the dotted line next to line 32 . . . . . **6.** _____

7. Subtract line 6 from line 5. If zero or less, **stop here.** None of your social security benefits are taxable . . . . . **7.** _____

8. Enter: $25,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2001; $32,000 if married filing jointly; -0- if married filing separately and you lived with your spouse at any time in 2001. . . . . **8.** _____

9. Is the amount on line 8 less than the amount on line 7?

☐ **No.** STOP None of your social security benefits are taxable. You do not have to enter any amounts on lines 20a or 20b of Form 1040. **But** if you are married filing separately and you **lived apart** from your spouse for all of 2001, enter -0- on line 20b. Be sure you entered "D" to the right of the word "benefits" on line 20a.

☐ **Yes.** Subtract line 8 from line 7 . . . . . **9.** _____

10. Enter: $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2001; $12,000 if married filing jointly; -0- if married filing separately and you lived with your spouse at any time in 2001. . . . . **10.** _____

11. Subtract line 10 from line 9. If zero or less, enter -0- . . . . . **11.** _____

12. Enter the **smaller** of line 9 or line 10. . . . . **12.** _____

13. Enter one-half of line 12 . . . . . **13.** _____

14. Enter the **smaller** of line 2 or line 13. . . . . **14.** _____

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- . . . . . **15.** _____

16. Add lines 14 and 15 . . . . . **16.** _____

17. Multiply line 1 by 85% (.85). . . . . **17.** _____

18. Taxable social security benefits. Enter the **smaller** of line 16 or line 17 . . . . . **18.** _____

- Enter the amount from line 1 above on Form 1040, line 20a.
- Enter the amount from line 18 above on Form 1040, line 20b.

TIP If part of your benefits are taxable for 2001 **and** they include benefits paid in 2001 that were for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.

Line 21

Other Income

Do not report on this line any income from **self-employment** or fees received as a notary public. Instead, you **must** use **Schedule C, C-EZ,** or **F,** even if you do not have any business expenses. Also, **do not** report on line 21 any nonemployee compensation shown on **Form 1099-MISC.** Instead, see the chart on page 18 to find out where to report that income.

Use line 21 to report any other income not reported on your return or other schedules. See examples below. List the type and amount of income. If necessary, show the required information on an attached statement. For more details, see **Miscellaneous Taxable Income** in **Pub. 525.**

Do not report any nontaxable income on line 21, such as an advance payment of your 2001 taxes; child support; money or property that was inherited, willed to you, or received as a gift; or life insurance proceeds received because of a person's death.

Examples of **income to report** on line 21 are:

- Prizes and awards.
- Gambling winnings, including lotteries, raffles, a lump-sum payment from the sale of a right to receive future lottery payments, etc. For details on gambling losses, see the instructions for **Schedule A,** line 27, on page A-6.
- Jury duty fees. Also, see the instructions for line 32 on page 30.
- Alaska Permanent Fund dividends.
- Qualified state tuition program earnings.
- Reimbursements or other amounts received for items deducted in an earlier year, such as medical expenses, real estate taxes, or home mortgage interest. See **Recoveries** in Pub. 525 for details on how to figure the amount to report.
- Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property. Also, see the instructions for line 32 on page 30.
- Income from an activity not engaged in for profit. See **Pub. 535.**
- Loss on certain corrective distributions of excess deferrals. See Pub. 525.

Adjusted Gross Income

Line 23

IRA Deduction

If you made any nondeductible contributions to a traditional individual retirement arrangement (IRA) for 2001, you **must** report them on **Form 8606.**

If you made contributions to a traditional IRA for 2001, you may be able to take an IRA deduction. But you, or your spouse if filing a joint return, must have had earned income to do so. For IRA purposes, earned income includes certain alimony received. See **Pub. 590** for details. You should receive a statement by May 31, 2002, that shows all contributions to your traditional IRA for 2001.

Use the worksheet on page 28 to figure the amount, if any, of your IRA deduction. **But read the following list before you fill in the worksheet.**

- If you were age 70½ or older at the end of 2001, you **cannot** deduct any contributions made to your traditional IRA for 2001 or treat them as nondeductible contributions.
- You **cannot** deduct contributions to a Roth IRA or a Coverdell education savings account.

If you made contributions to both a traditional IRA and a Roth IRA for 2001, **do not** use the worksheet on page 28. Instead, use the worksheet in **Pub. 590** to figure the amount, if any, of your IRA deduction.

- You **cannot** deduct contributions to a 401(k) plan, section 457 plan, SIMPLE plan, or the Federal Thrift Savings Plan. These amounts are not included as income in box 1 of your W-2 form.
- If you made contributions to your IRA in 2001 that you deducted for 2000, **do not** include them in the worksheet.
- If you received a distribution from a nonqualified deferred compensation plan or section 457 plan that is included in box 1 of your W-2 form, **do not** include that distribution on line 8 of the worksheet. The distribution should be shown in box 11 of your W-2 form. If it is not, contact your employer for the amount of the distribution.
- You must file a joint return to deduct contributions to your spouse's IRA. Enter the total IRA deduction for you and your spouse on line 23.
- Do not include rollover contributions in figuring your deduction. Instead, see the instructions for lines 15a and 15b on page 23.
- Do not include trustees' fees that were billed separately and paid by you for your IRA. These fees can be deducted only as an itemized deduction on **Schedule A.**
- If the total of your IRA deduction on line 23 plus any nondeductible contribution to your traditional IRAs shown on Form 8606 is less than your total traditional IRA contributions for 2001, see Pub. 590 for special rules.

By April 1 of the year after the year in which you turn age 70½, you must start taking minimum required distributions from your traditional IRA. If you do not, you may have to pay a 50% additional tax on the amount that should have been distributed. For details, including how to figure the minimum required distribution, see Pub. 590.

Were You Covered by a Retirement Plan?

If you were covered by a retirement plan (qualified pension, profit-sharing (including 401(k)), annuity, SEP, SIMPLE, etc.) at work or through self-employment, your IRA deduction may be reduced or eliminated. But you can still make contributions to an IRA even if you cannot deduct them. In any case, the income earned on your IRA contributions is not taxed until it is paid to you.

The "Retirement plan" box in box 13 of your W-2 form should be checked if you were covered by a plan at work even if you were not vested in the plan. You are also covered by a plan if you were self-employed and had a SEP, SIMPLE, or qualified retirement plan.

If you were covered by a retirement plan and you file **Form 2555, 2555-EZ,** or **8815,** or you exclude employer-provided adoption benefits, see Pub. 590 to figure the amount, if any, of your IRA deduction.

Married Persons Filing Separately. If you were not covered by a retirement plan but your spouse was, **you** are considered covered by a plan unless you **lived apart** from your spouse for all of 2001.

Need more information or forms? See page 7.

Line 24

Student Loan Interest Deduction

Use the worksheet on page 29 to figure your student loan interest deduction if **all five** of the following apply.

1. You paid interest in 2001 on a qualified student loan (see page 29).

2. At least part of the interest paid in 2001 was paid during the first 60 months that interest payments were required to be made. See **Example** on page 29.

3. Your filing status is any status **except** married filing separately.

4. Your modified adjusted gross income (AGI) is less than: $55,000 if single, head of household, or qualifying widow(er); $75,000 if married filing jointly. Use lines 3 through 5 of the worksheet on page 29 to figure your modified AGI.

5. You are not claimed as a dependent on someone's (such as your parent's) 2001 tax return.

Exception. Use **Pub. 970** instead of the worksheet on page 29 to figure your student loan interest deduction if you file **Form 2555, 2555-EZ,** or **4563**, or you exclude income from sources within Puerto Rico.

IRA Deduction Worksheet—Line 23

Keep for Your Records

Before you begin:

√ Complete Form 1040, lines 25 through 31a, if they apply to you.

√ Figure any amount to be entered on the dotted line next to line 32 (see page 30).

√ Be sure you have read the list on page 27.

		Your IRA	Spouse's IRA
1a.	Were you covered by a retirement plan (see page 27)?	**1a.** ☐ **Yes** ☐ **No**	
1b.	If married filing jointly, was your spouse covered by a retirement plan?		**1b.** ☐ **Yes** ☐ **No**
	Next. If you checked "No" on line 1a, and, if married filing jointly, "No" on line 1b, skip lines 2–6, enter $2,000 on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.		
2.	Enter the amount shown below that applies to you. • Single, head of household, or married filing separately and you **lived apart** from your spouse for all of 2001, enter $43,000 • Qualifying widow(er), enter $63,000 • Married filing jointly, enter $63,000 in both columns. But if you checked "No" on either line 1a or 1b, enter $160,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2001, enter $10,000	**2a.**	**2b.**
3.	Enter the amount from Form 1040, line 22 **3.**		
4.	Add amounts on Form 1040, lines 25 through 31a, and any amount you entered on the dotted line next to line 32 **4.**		
5.	Subtract line 4 from line 3. Enter the result in both columns	**5a.**	**5b.**
6.	Is the amount on line 5 less than the amount on line 2?		
	☐ **No.** STOP None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606.		
	☐ **Yes.** Subtract line 5 from line 2 in each column. **If the result is $10,000 or more, enter $2,000 on line 7 for that column**	**6a.**	**6b.**
7.	Multiply lines 6a and 6b by 20% (.20). If the result is not a multiple of $10, increase it to the next multiple of $10 (for example, increase $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200	**7a.**	**7b.**
8.	Enter your wages, and your spouse's if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 27 and 29. Do not reduce wages by any loss from self-employment **8.**		
	CAUTION If married filing jointly and line 8 is less than $4,000, **stop here** and see Pub. 590 to figure your IRA deduction.		
9.	Enter traditional IRA contributions made, or that will be made by April 15, 2002, for 2001 to your IRA on line 9a and to your spouse's IRA on line 9b	**9a.**	**9b.**
10.	On line 10a, enter the **smallest** of line 7a, 8, or 9a. On line 10b, enter the **smallest** of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 23. Or, if you want, you may deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	**10a.**	**10b.**

Example. You took out a qualified student loan in 1994 while in college. You had 6 years to repay the loan and your first monthly payment was due July 1996, after you graduated. You made a payment every month as required. If you meet items **3** through **5** listed on page 28, you may use only the interest you paid for January through June 2001 to figure your deduction. June is the end of the 60-month period (July 1996–June 2001).

Qualified Student Loan. This is any loan you took out to pay the qualified higher education expenses for yourself, your spouse, or anyone who was your dependent when the loan was taken out. The person for whom the expenses were paid must have been an eligible student (defined on this page). However, a loan is not a qualified student loan if **(a)** any of the proceeds were used for other purposes or **(b)** the loan was from either a related person or a person who borrowed the proceeds under a qualified employer plan or a contract purchased under such a plan. To find out who is a related person, see Pub. 970.

Qualified higher education expenses generally include tuition, fees, room and board, and related expenses such as books and supplies. The expenses must be for education in a degree, certificate, or similar program at an eligible educational institution. An eligible educational institution includes most colleges, universities, and certain vocational schools. You must reduce the expenses by the following nontaxable benefits.

- Employer-provided educational assistance benefits that are not included in box 1 of your W-2 form(s).
- Excludable U.S. series EE and I savings bond interest from **Form 8815.**
- Qualified distributions from a Coverdell education savings account.
- Any scholarship, educational assistance allowance, or other payment (but **not** gifts, inheritances, etc.) excluded from income.

For more details on these expenses, see Pub. 970.

An **eligible student** is a person who:

- Was enrolled in a degree, certificate, or other program (including a program of study abroad that was approved for credit by the institution at which the student was enrolled) leading to a recognized educational credential at an eligible educational institution **and**
- Carried at least half the normal full-time workload for the course of study he or she was pursuing.

Line 25

Archer MSA Deduction

If you made a contribution to an Archer MSA for 2001, you may be able to take this deduction. See **Form 8853.**

Line 26

Moving Expenses

If you moved in connection with your job or business or started a new job, you may be able to take this deduction. But your new workplace must be at least 50 miles farther from your old home than your old home was from your old workplace. If you had no former workplace, your new workplace must be at least 50 miles from your old home. Use TeleTax topic 455 (see page 11) or see **Form 3903.**

Student Loan Interest Deduction Worksheet—Line 24

Keep for Your Records

Before you begin:

- √ Complete Form 1040, lines 25 through 31a, if they apply to you.
- √ Figure any amount to be entered on the dotted line next to line 32 (see page 30).
- √ See the instructions for line 24 that begin on page 28.
- √ Be sure you have read the **Exception** on page 28 to see if you can use this worksheet instead of Pub. 970 to figure your deduction.

1. Enter the total interest you paid in 2001 on qualified student loans (defined above). Do not include interest that was required to be paid after the first 60 months		**1.** _____
2. Enter the **smaller** of line 1 or $2,500		**2.** _____
3. Enter the amount from Form 1040, line 22	**3.** _____	
4. Enter the total of the amounts from Form 1040, line 23, lines 25 through 31a, plus any amount you entered on the dotted line next to line 32	**4.** _____	
5. Subtract line 4 from line 3	**5.** _____	
6. Enter the amount shown below for your filing status. • Single, head of household, or qualifying widow(er)—$40,000 • Married filing jointly—$60,000	**6.** _____	
7. Is the amount on line 5 more than the amount on line 6? ☐ **No.** Skip lines 7 and 8, enter -0- on line 9, and go to line 10. ☐ **Yes.** Subtract line 6 from line 5	**7.** _____	
8. Divide line 7 by $15,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"		**8.** . _____
9. Multiply line 2 by line 8		**9.** _____
10. Student loan interest deduction. Subtract line 9 from line 2. Enter the result here and on Form 1040, line 24. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)		**10.** _____

Need more information or forms? See page 7.

Line 27

One-Half of Self-Employment Tax

If you were self-employed and owe self-employment tax, fill in **Schedule SE** to figure the amount of your deduction.

Line 28

Self-Employed Health Insurance Deduction

You may be able to deduct part of the amount paid for health insurance for yourself, your spouse, and dependents if **either** of the following applies.

- You were self-employed and had a net profit for the year.
- You received wages in 2001 from an S corporation in which you were a more-than-2% shareholder. Health insurance benefits paid for you may be shown in box 14 of your W-2 form.

The insurance plan must be established under your business. But if you were also eligible to participate in any subsidized health plan maintained by your or your spouse's employer for any month or part of a month in 2001, amounts paid for health insurance coverage for that month cannot be used to figure the deduction. For example, if you were eligible to participate in a subsidized health plan maintained by your spouse's employer from September 30 through December 31, you cannot use amounts paid for health insurance coverage for September through December to figure your deduction. For more details, see **Pub. 535.**

If you qualify to take the deduction, use the worksheet below to figure the amount you can deduct.

Exception. Use Pub. 535 instead of the worksheet below to find out how to figure your deduction if **any** of the following apply.

- You had more than one source of income subject to self-employment tax.
- You file **Form 2555** or **2555-EZ.**
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

Line 29

Self-Employed SEP, SIMPLE, and Qualified Plans

If you were self-employed or a partner, you may be able to take this deduction. See **Pub. 560** or, if you were a minister, **Pub. 517.**

Line 30

Penalty on Early Withdrawal of Savings

The **Form 1099-INT** or **Form 1099-OID** you received will show the amount of any penalty you were charged.

Lines 31a and 31b

Alimony Paid

If you made payments to or for your spouse or former spouse under a divorce or separation instrument, you may be able to take this deduction. Use TeleTax topic 452 (see page 11) or see **Pub. 504.**

Line 32

Include in the total on line 32 any of the following adjustments. To find out if you can take the deduction, see the form or publication indicated. On the dotted line next to line 32, enter the amount of your deduction and identify it as indicated.

- Performing-arts-related expenses (see **Form 2106** or **2106-EZ**). Identify as "QPA."
- Jury duty pay given to your employer (see **Pub. 525**). Identify as "Jury Pay."
- Deductible expenses related to income reported on line 21 from the rental of personal property engaged in for profit. Identify as "PPR."
- Reforestation amortization (see **Pub. 535**). Identify as "RFST."
- Repayment of supplemental unemployment benefits under the Trade Act of 1974 (see **Pub. 525**). Identify as "Sub-Pay TRA."
- Contributions to section 501(c)(18) pension plans (see **Pub. 525**). Identify as "501(c)(18)."
- Contributions by certain chaplains to section 403(b) plans (see **Pub. 517**). Identify as "403(b)."
- Deduction for clean-fuel vehicles (see **Pub. 535**). Identify as "Clean-Fuel."
- Employee business expenses of fee-basis state or local government officials (see **Form 2106** or **2106-EZ**). Identify as "FBO."

Self-Employed Health Insurance Deduction Worksheet—Line 28

Keep for Your Records

Before you begin:

√ Complete Form 1040, line 29, if it applies to you.

√ Be sure you have read the **Exception** above to see if you can use this worksheet instead of Pub. 535 to figure your deduction.

1. Enter the total amount paid in 2001 for health insurance coverage established under your business for 2001 for you, your spouse, and dependents. But do not include amounts for any month you were eligible to participate in an employer-sponsored health plan	**1.**	
2. Multiply line 1 by 60% (.60)	**2.**	
3. Enter your net profit and any other earned income* from the business under which the insurance plan is established, minus any deductions you claim on Form 1040, lines 27 and 29	**3.**	
4. Self-employed health insurance deduction. Enter the **smaller** of line 2 or line 3 here and on Form 1040, line 28. **Do not** include this amount in figuring any medical expense deduction on Schedule A (Form 1040)	**4.**	

* ***Earned income*** *includes net earnings and gains from the sale, transfer, or licensing of property you created. It does not include capital gain income. If you were a more-than-2% shareholder in the S corporation under which the insurance plan is established, earned income is your wages from that corporation.*

Line 33

If line 33 is less than zero, you may have a net operating loss that you can carry to another tax year. See **Pub. 536.**

Tax and Credits

Line 35a

If you were age 65 or older or blind, check the appropriate box(es) on line 35a. If you were married and checked the box on line 6b of Form 1040 and your spouse was age 65 or older or blind, also check the appropriate box(es) for your spouse. Be sure to enter the total number of boxes checked.

Age

If you were age 65 or older on January 1, 2002, check the "65 or older" box on your 2001 return.

Blindness

If you were partially blind as of December 31, 2001, you must get a statement certified by your eye doctor or registered optometrist that:

- You cannot see better than 20/200 in your better eye with glasses or contact lenses or
- Your field of vision is 20 degrees or less.

If your eye condition is not likely to improve beyond the conditions listed above, you can get a statement certified by your eye doctor or registered optometrist to this effect instead.

You must keep the statement for your records.

Line 35b

If your spouse itemizes deductions on a separate return or if you were a dual-status alien, check the box on line 35b. But if you were a dual-status alien and you file a joint return with your spouse who was a U.S. citizen or resident at the end of 2001 and you and your spouse agree to be taxed on your combined worldwide income, **do not** check the box.

Line 36

Itemized Deductions or Standard Deduction

In most cases, your Federal income tax will be less if you take the **larger** of:

- Your itemized deductions or
- Your standard deduction.

CAUTION If you checked the box on **line 35b,** your standard deduction is zero.

Itemized Deductions

To figure your itemized deductions, fill in **Schedule A.**

Standard Deduction

Most people can find their standard deduction by looking at the amounts listed under "All others" to the left of line 36 of Form 1040. But if you checked **any** box on **line 35a, or** you (or your spouse if filing jointly) can be claimed as a dependent on someone's 2001 return, use the worksheet below or the chart on page 32, whichever applies, to figure your standard deduction. Also, if you checked the box on **line 35b,** your standard deduction is zero, even if you were age 65 or older or blind.

Electing To Itemize for State Tax or Other Purposes

If you itemize even though your itemized deductions are less than your standard deduction, enter "IE" on the dotted line next to line 36.

Standard Deduction Worksheet for Dependents—Line 36

Keep for Your Records

Use this worksheet **only** if someone can claim you, or your spouse if filing jointly, as a dependent.

1.	Add $250 to your **earned income*.** Enter the total	**1.**	
2.	Minimum standard deduction	**2.**	**750.00**
3.	Enter the **larger** of line 1 or line 2	**3.**	
4.	Enter the amount shown below for your filing status. • Single—$4,550 • Married filing separately—$3,800 • Married filing jointly or qualifying widow(er)—$7,600 • Head of household—$6,650	**4.**	
5.	**Standard deduction.**		
a.	Enter the **smaller** of line 3 or line 4. If under 65 and not blind, **stop here** and enter this amount on Form 1040, line 36. **Otherwise,** go to line 5b	**5a.**	
b.	If 65 or older or blind, multiply the number on Form 1040, line 35a, by: $1,100 if single or head of household; $900 if married filing jointly or separately, or qualifying widow(er)	**5b.**	
c.	Add lines 5a and 5b. Enter the total here and on Form 1040, line 36	**5c.**	

***Earned income** includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income. Generally, your earned income is the total of the amount(s) you reported on Form 1040, lines 7, 12, and 18, minus the amount, if any, on line 27.*

Need more information or forms? See page 7.

Standard Deduction Chart for People Age 65 or Older or Blind—Line 36

Do not use this chart if someone can claim you, or your spouse if filing jointly, as a dependent. Instead use the worksheet on page 31.

Enter the number from the box on line 35a of Form 1040 . . . . . ▶ ☐

CAUTION Do not use the number of exemptions from line 6d.

IF your filing status is . . .	AND the number in the box above is . . .	THEN your standard deduction is . . .
Single	1	$5,650
	2	6,750
Married filing jointly or Qualifying widow(er)	1	$8,500
	2	9,400
	3	10,300
	4	11,200
Married filing separately	1	$4,700
	2	5,600
	3	6,500
	4	7,400
Head of household	1	$7,750
	2	8,850

Deduction for Exemptions Worksheet—Line 38

Keep for Your Records

1. Is the amount on Form 1040, line 34, more than the amount shown on line 4 below for your filing status?

☐ **No.** STOP Multiply $2,900 by the total number of exemptions claimed on Form 1040, line 6d, and enter the result on line 38.

☐ **Yes.** *Continue*

2. Multiply $2,900 by the total number of exemptions claimed on Form 1040, line 6d . . . . . **2.** _____

3. Enter the amount from Form 1040, line 34 . . . . . **3.** _____

4. Enter the amount shown below for your filing status.

- Single—$132,950
- Married filing jointly or qualifying widow(er)—$199,450
- Married filing separately—$99,725
- Head of household—$166,200

. . . **4.** _____

5. Subtract line 4 from line 3 . . . . . **5.** _____

Note. If line 5 is more than: $122,500 if single, married filing jointly, head of household, or qualifying widow(er); $61,250 if married filing separately, **stop here.** You **cannot** take a deduction for exemptions.

6. Divide line 5 by: $2,500 if single, married filing jointly, head of household, or qualifying widow(er); $1,250 if married filing separately. If the result is not a whole number, increase it to the next higher whole number (for example, increase 0.0004 to 1) . . . . . **6.** _____

7. Multiply line 6 by 2% (.02) and enter the result as a decimal . . . . . **7.** _____

8. Multiply line 2 by line 7 . . . . . **8.** _____

9. **Deduction for exemptions.** Subtract line 8 from line 2. Enter the result here and on Form 1040, line 38 **9.** _____

Line 40

Tax

Do you want the IRS to figure your tax for you?

☐ **Yes.** See **Pub. 967** for details, including who is eligible and what to do. If you have paid too much, we will send you a refund. If you did not pay enough, we will send you a bill.

☐ **No.** Use one of the following methods to figure your tax. Also include in the total on line 40 any of the following taxes.

- Tax from **Forms 8814** and **4972.** Be sure to check the appropriate box(es).
- Tax from recapture of an education credit. You may owe this tax if **(a)** you claimed an education credit in an earlier year **and (b)** you, your spouse if filing jointly, or your dependent received in 2001 either tax-free educational assistance or a refund of qualified expenses. See **Form 8863** for more details. If you owe this tax, enter the amount and "ECR" on the dotted line next to line 40.

Tax Table or Tax Rate Schedules. If your taxable income is less than $100,000, you **must** use the Tax Table, which starts on page 59, to figure your tax. Be sure you use the correct column. If your taxable income is $100,000 or more, use the Tax Rate Schedules on page 71.

Exception. Do not use the Tax Table or Tax Rate Schedules to figure your tax if **either 1** or **2** below applies.

1. You are required to figure your tax using the **Tax Computation Worksheet for Certain Dependents** below, **Form 8615, Schedule D,** or the **Capital Gain Tax Worksheet** on page 34.

2. You use **Schedule J** (for farm income) to figure your tax.

Tax Computation Worksheet for Certain Dependents. If you, or your spouse if filing jointly, can be claimed as a dependent on someone's 2001 return, you must use the worksheet below to figure your tax unless you received (before offset) an advance payment of your 2001 taxes. If any of the other methods listed in item **1** or **2** above apply to you, follow the **Special Rules** on the worksheet to figure your tax. Your tax may be less if this worksheet applies.

Form 8615. Form 8615 must generally be used to figure the tax for any child who was under age 14 on January 1, 2002, and who had more than $1,500 of investment income, such as taxable interest, ordinary dividends, or capital gains (including capital gain distributions). But if neither of the child's parents was alive on December 31, 2001, do not use Form 8615 to figure the child's tax.

Schedule D. If you had a net capital gain on Schedule D (both lines 16 and 17 of Schedule D are gains) and the amount on Form 1040, line 39, is more than zero, use Part IV of Schedule D to figure your tax.

Capital Gain Tax Worksheet. If you received capital gain distributions but you are not required to file Schedule D, use the worksheet on page 34 to figure your tax.

Schedule J. If you had income from farming, your tax may be less if you choose to figure it using income averaging on Schedule J.

Tax Computation Worksheet for Certain Dependents—Line 40

Keep for Your Records

Before you begin:

√ Be sure you can use this worksheet (see **Tax Computation Worksheet for Certain Dependents** above).

√ **Do not** use this worksheet if you, or your spouse if filing jointly, received (before offset) an advance payment of your 2001 taxes.

√ Be sure you read the **Special Rules** below.

1. Figure the tax on the amount on Form 1040, line 39 (or the applicable line of the worksheet, schedule, or form listed below). Use the Tax Table or Tax Rate Schedules, whichever applies . . . . . **1.** _____

2. Is the amount on line 1 more than the amount shown below for your filing status?

- Single or married filing separately—$900
- Married filing jointly or qualifying widow(er)—$1,800
- Head of household—$1,500

☐ **Yes.** Enter: $300 if single or married filing separately; $500 if head of household; $600 if married filing jointly or qualifying widow(er). } . . . . . **2.** _____

☐ **No.** Divide the amount on line 1 by 3.0.

3. Subtract line 2 from line 1. Enter the result here and on Form 1040, line 40 (or the applicable line of the worksheet, schedule, or form listed below) . . . . . **3.** _____

Special Rules. If you use:

- The **Capital Gain Tax Worksheet** on page 34, use the worksheet above to figure the tax on lines 4 and 14 of the Capital Gain Tax Worksheet.
- **Schedule D, Part IV,** use the worksheet above to figure the tax on lines 25 and 39 of Part IV. If you use the **Schedule D Tax Worksheet** on page D-9, use the worksheet above to figure the tax on lines 15 and 36 of the Schedule D Tax Worksheet.
- **Schedule J,** use the worksheet above to figure the tax on line 4 of Schedule J.
- **Form 8615,** use the worksheet above to figure the tax on lines 15 and 17 of Form 8615 (and line 9 if the parent used this worksheet).
- **Other forms or worksheets** that require you to figure the tax using the 2001 Tax Table or Tax Rate Schedules, use the worksheet above to figure the tax on any line that would otherwise be figured using the 2001 Tax Table or Tax Rate Schedules.

Need more information or forms? See page 7.

Line 41

Alternative Minimum Tax

Use the worksheet on page 35 to see if you should fill in **Form 6251.**

Exception. Fill in Form 6251 instead of using the worksheet on page 35 if you claimed or received **any** of the following items.

1. Accelerated depreciation.

2. Stock by exercising an incentive stock option and you did not dispose of the stock in the same year.

3. Tax-exempt interest from private activity bonds.

4. Intangible drilling, circulation, research, experimental, or mining costs.

5. Amortization of pollution-control facilities or depletion.

6. Income or (loss) from tax-shelter farm activities or passive activities.

7. Percentage-of-completion income from long-term contracts.

8. Interest paid on a home mortgage **not** used to buy, build, or substantially improve your home.

9. Investment interest expense reported on **Form 4952.**

10. Net operating loss deduction.

11. Alternative minimum tax adjustments from an estate, trust, electing large partnership, or cooperative.

12. Section 1202 exclusion.

CAUTION Form 6251 should be filled in for a child under age 14 if the child's adjusted gross income from Form 1040, line 34, exceeds the child's earned income by more than $5,350.

Line 43

Foreign Tax Credit

If you paid income tax to a foreign country, you may be able to take this credit. Generally, you must complete and attach **Form 1116** to do so.

Exception. You do not have to file Form 1116 to take this credit if **all five** of the following apply.

1. All of your gross foreign-source income is from interest and dividends and all of that income and the foreign tax paid on it is reported to you on **Form 1099-INT** or **Form 1099-DIV** (or substitute statement).

2. If you have dividend income from shares of stock, you held those shares for at least 16 days.

3. You are not filing **Form 4563** or excluding income from sources within Puerto Rico.

4. The total of your foreign taxes is not more than $300 (not more than $600 if married filing jointly).

5. All of your foreign taxes were:

- Legally owed and not eligible for a refund and
- Paid to countries that are recognized by the United States and do not support terrorism.

(Continued on page 35)

Capital Gain Tax Worksheet—Line 40

Keep for Your Records

Before you begin:
√ Be sure you do not have to file Schedule D (see the instructions for Form 1040, line 13, on page 23).
√ Be sure you checked the box on line 13 of Form 1040.

1.	Enter the amount from Form 1040, line 39	**1.**	
2.	Enter the amount from Form 1040, line 13	**2.**	
3.	Subtract line 2 from line 1. If zero or less, enter -0-	**3.**	
4.	Figure the tax on the amount on line 3. Use the Tax Table or Tax Rate Schedules, whichever applies		**4.**
5.	Enter the **smaller** of: ● The amount on line 1 or ● $27,050 if single; $45,200 if married filing jointly or qualifying widow(er); $22,600 if married filing separately; or $36,250 if head of household.	**5.**	
6.	Is the amount on line 3 equal to or more than the amount on line 5? ☐ **Yes.** Leave lines 6 through 8 blank; go to line 9 and check the "No" box. ☐ **No.** Enter the amount from line 3	**6.**	
7.	Subtract line 6 from line 5	**7.**	
8.	Multiply line 7 by 10% (.10)		**8.**
9.	Are the amounts on lines 2 and 7 the same? ☐ **Yes.** Leave lines 9 through 12 blank; go to line 13. ☐ **No.** Enter the **smaller** of line 1 or line 2	**9.**	
10.	Enter the amount, if any, from line 7	**10.**	
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	
12.	Multiply line 11 by 20% (.20)		**12.**
13.	Add lines 4, 8, and 12		**13.**
14.	Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies		**14.**
15.	**Tax on all taxable income (including capital gain distributions).** Enter the **smaller** of line 13 or line 14 here and on Form 1040, line 40		**15.**

For more details on these requirements, see the Instructions for Form 1116.

Do you meet all five requirements on page 34?

☐ **Yes.** Enter on line 43 the **smaller** of your total foreign taxes or the amount on Form 1040, line 40.

☐ **No.** See Form 1116 to find out if you can take the credit and, if you can, if you have to file Form 1116.

Line 44

Credit for Child and Dependent Care Expenses

You may be able to take this credit if you paid someone to care for your child **under age 13** or your dependent or spouse who could not care for himself or herself. For details, use TeleTax topic 602 (see page 11) or see **Form 2441.**

Line 45

Credit for the Elderly or the Disabled

You may be able to take this credit if by the end of 2001 **(a)** you were age 65 or older or **(b)** you retired on **permanent and total disability** and you had taxable disability income. But you usually **cannot** take the credit if the amount on Form 1040, line 34, is $17,500 or more ($20,000 if married filing jointly and only one spouse is eligible for

Worksheet To See if You Should Fill in Form 6251—Line 41

Keep for Your Records

Before you begin:

√ Be sure you have read the **Exception** on page 34 to see if you must fill in Form 6251 instead of using this worksheet.

√ If you are claiming the foreign tax credit (see the instructions for Form 1040, line 43, that begin on page 34), enter that credit on line 43.

1. Enter the amount from Form 1040, line 37 . . . . . **1.** _____

2. Are you filing **Schedule A?**

☐ **Yes.** Leave line 2 blank and go to line 3.

☐ **No.** Enter your standard deduction from Form 1040, line 36, and go to line 5. . . . . **2.** _____

3. Enter the **smaller** of the amount on Schedule A, line 4, or 2.5% (.025) of the amount on Form 1040, line 34 . . . . . **3.** _____

4. Add lines 9 and 26 of Schedule A and enter the total . . . . . **4.** _____

5. Add lines 1 through 4 above . . . . . **5.** _____

6. Enter the amount shown below for your filing status.
- Single or head of household—$35,750
- Married filing jointly or qualifying widow(er)—$49,000
- Married filing separately—$24,500

. . . . . **6.** _____

7. Is the amount on line 5 more than the amount on line 6?

☐ **No.** STOP You do not need to fill in Form 6251.

☐ **Yes.** Subtract line 6 from line 5 . . . . . **7.** _____

8. Enter the amount shown below for your filing status.
- Single or head of household—$112,500
- Married filing jointly or qualifying widow(er)—$150,000
- Married filing separately—$75,000

. . . . . **8.** _____

9. Is the amount on line 5 more than the amount on line 8?

☐ **No.** Enter -0- here and on line 10 and go to line 11.

☐ **Yes.** Subtract line 8 from line 5.

. . . . . **9.** _____

10. Multiply line 9 by 25% (.25) and enter the result but do not enter more than line 6 above . . . **10.** _____

11. Add lines 7 and 10 . . . . . **11.** _____

12. Is the amount on line 11 more than the amount shown below for your filing status?
- Single, married filing jointly, head of household, or qualifying widow(er)—$175,000
- Married filing separately—$87,500

☐ **Yes.** STOP Fill in Form 6251 to see if you owe the alternative minimum tax.

☐ **No.** Multiply line 11 by 26% (.26) . . . . . **12.** _____

13. Enter the amount from Form 1040, line 40, minus the total of any tax from Form 4972 and any amount on Form 1040, line 43 . . . . . **13.** _____

Next. Is the amount on line 12 more than the amount on line 13?

☐ **Yes.** Fill in Form 6251 to see if you owe the alternative minimum tax.

☐ **No.** You do not need to fill in Form 6251.

Need more information or forms? See page 7.

the credit; $25,000 if married filing jointly and both spouses are eligible; $12,500 if married filing separately). See **Schedule R** and its instructions for details.

Credit Figured by the IRS. If you can take this credit and you want us to figure it for you, see the Instructions for Schedule R.

Line 46

Education Credits

If you (or your dependent) paid qualified expenses in 2001 for yourself, your spouse, or your dependent to enroll in or attend an eligible educational institution, you may be able to take an education credit. See **Form 8863** for details. However, you **cannot** take an education credit if **any** of the following apply.

- You are claimed as a dependent on someone's (such as your parent's) 2001 tax return.
- Your filing status is married filing separately.
- The amount on Form 1040, line 34, is $50,000 or more ($100,000 or more if married filing jointly).
- You (or your spouse) were a nonresident alien for any part of 2001 unless your filing status is married filing jointly.

Rate Reduction Credit Worksheet—Line 47

Keep for Your Records

Before you begin:

√ If you received (before offset) an advance payment of your 2001 taxes equal to the amount shown below for your 2001 filing status, **stop.** You cannot take the credit because you have received the maximum amount of the credit.

- Single or married filing separately — $300
- Head of household — $500
- Married filing jointly or qualifying widow(er) — $600

√ If you, or your spouse if filing a joint return, can be claimed as a dependent on another person's return, **stop.** You cannot take the credit.

√ If you received (before offset) an advance payment and you filed a joint return for 2000, you and your spouse are each considered to have received one-half of the payment.

TIP If you received Notice 1275, 1277, or 1278 have it available. The notice shows the amount of your advance payment (before offset).

1. Enter the amount from Form 1040, line 39. If line 39 is zero or blank, **stop;** you cannot take the credit . . . **1.** _____

2. Enter the amount shown below for your filing status.
- Single or married filing separately — $6,000
- Head of household — $10,000
- Married filing jointly or qualifying widow(er) — $12,000

. . . . . **2.** _____

3. Is the amount on line 1 less than the amount on line 2?

No. Enter: $300 if single or married filing separately; $500 if head of household; $600 if married filing jointly or qualifying widow(er).

Yes. Multiply the amount on line 1 by 5% (.05). Enter the result.

. . . . . **3.** _____

4. Enter the amount from Form 1040, line 42 . . . . . **4.** _____

5. Add the amounts from Form 1040, lines 43 through 46. Enter the total . . . **5.** _____

6. Subtract line 5 from line 4. If the result is zero or less, **stop;** you cannot take the credit . . . . . **6.** _____

7. Enter the **smaller** of line 3 or line 6 . . . . . **7.** _____

8. Enter the amount, if any, of your advance payment (before offset). If filing a joint return, include your spouse's advance payment with yours . . . . . **8.** _____

9. Rate reduction credit. Subtract line 8 from line 7. Enter the result here and, if more than zero, on Form 1040, line 47. If line 8 is more than line 7, you do not have to pay back the difference . . . . **9.** _____

Need more information or forms? See page 7.

Line 48—Child Tax Credit

What Is the Child Tax Credit?

This credit is for people who have a qualifying child as defined in the instructions for line 6c, column (4), on page 20. It is in addition to the credit for child and dependent care expenses on Form 1040, line 44, and the earned income credit on Form 1040, line 61a.

Three Steps To Take the Child Tax Credit!

Step 1. Make sure you have a qualifying child for the child tax credit. See the instructions for line 6c, column (4), on page 20.

Step 2. Make sure you checked the box in column (4) of line 6c on Form 1040 for each qualifying child.

Step 3. Answer the questions on this page to see if you may use the worksheet on page 38 to figure your credit or if you must use Pub. 972, Child Tax Credit. If you need Pub. 972, see page 7.

Questions **Who Must Use Pub. 972**

1. Are you excluding income from Puerto Rico **or** are you filing any of the following forms?

- Form 2555 or 2555-EZ (relating to foreign earned income)
- Form 4563 (exclusion of income for residents of American Samoa)

☐ **No.** *Continue* ➘

☐ **Yes.** STOP
You must use Pub. 972 to figure your credit.

---

2. Is the amount on Form 1040, line 34, more than the amount shown below for your filing status?

- Married filing jointly – $110,000
- Single, head of household, or qualifying widow(er) – $75,000
- Married filing separately – $55,000

☐ **No.** *Continue* ➘

☐ **Yes.** STOP
You must use Pub. 972 to figure your credit.

---

3. Are you claiming any of the following credits?

- Adoption credit, Form 8839 (see the instructions for Form 1040, line 49, on page 39)
- Mortgage interest credit, Form 8396 (see the instructions for Form 1040, line 50, on page 39)
- District of Columbia first-time homebuyer credit, Form 8859

☐ **No.** Use the worksheet on page 38 to figure your child tax credit.

☐ **Yes.** You must use Pub. 972 to figure your child tax credit. You will also need the form(s) listed above for any credit(s) you are claiming.

Need more information or forms? See page 7.

Child Tax Credit Worksheet—Line 48

Keep for Your Records

CAUTION

Do not use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 37. Instead, use Pub. 972.

1. Number of qualifying children: _____ × $600. Enter the result. | **1** |

2. Enter the amount from Form 1040, line 42. | **2** |

3. Add the amounts from Form 1040:

Line 43 _____

Line 44 + _____

Line 45 + _____

Line 46 + _____

Line 47 + _____ Enter the total. | **3** |

4. Are the amounts on lines 2 and 3 the same?

☐ **Yes.** STOP

You cannot take this credit because there is no tax to reduce. However, see the **TIP** below before completing the rest of your Form 1040.

☐ **No.** Subtract line 3 from line 2. | **4** |

5. Is the amount on line 1 more than the amount on line 4?

☐ **Yes.** Enter the amount from line 4. Also, see the **TIP** below.

☐ **No.** Enter the amount from line 1.

This is your child tax credit.

| **5** |

Enter this amount on Form 1040, line 48.

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 63, if you answered "Yes" on line 4 **or** line 5 above.

- First, complete your Form 1040 through line 62.
- Then, use Form 8812 to figure any additional child tax credit.

Line 49

Adoption Credit

You may be able to take this credit if you paid expenses in 2001 to adopt a child. See **Form 8839** for details.

Line 50

Other Credits

Include in the total on line 50 any of the following credits and check the appropriate box(es). If box **d** is checked, also enter the form number. To find out if you can take the credit, see the form or publication indicated.

- Mortgage interest credit. If a state or local government gave you a mortgage credit certificate, see **Form 8396.**
- Credit for prior year minimum tax. If you paid alternative minimum tax in a prior year, see **Form 8801.**
- Qualified electric vehicle credit. If you placed a new electric vehicle in service in 2001, see **Form 8834.**
- General business credit. This credit consists of a number of credits that usually apply only to individuals who are partners, shareholders in an S corporation, self-employed, or who have rental property. See **Form 3800** or **Pub. 334.**
- Empowerment zone employment credit. See **Form 8844.**
- District of Columbia first-time homebuyer credit. See **Form 8859.**

Line 51

If you sold fuel produced from a nonconventional source, see Internal Revenue Code section 29 to find out if you can take the **nonconventional source fuel credit.** If you can, attach a schedule showing how you figured the credit. Include the credit in the total on line 51. Enter the amount and "FNS" on the dotted line next to line 51.

Other Taxes

Line 54

Social Security and Medicare Tax on Tip Income Not Reported to Employer

If you received tips of $20 or more in any month and you did not report the full amount to your employer, you must pay the social security and Medicare or railroad retirement (RRTA) tax on the unreported tips. You must also pay this tax if your W-2 form(s) shows allocated tips that you are including in your income on Form 1040, line 7.

To figure the tax, use **Form 4137.** To pay the RRTA tax, contact your employer. Your employer will figure and collect the tax.

You may be charged a penalty equal to 50% of the social security and Medicare tax due on tips you received but did not report to your employer.

Line 55

Tax on Qualified Plans Including IRAs, and Other Tax-Favored Accounts

If **any** of the following apply, see **Form 5329** and its instructions to find out if you owe this tax and if you must file Form 5329.

1. You received any early distributions from **(a)** an IRA or other qualified retirement plan, **(b)** an annuity, or **(c)** a modified endowment contract entered into after June 20, 1988.

2. Excess contributions were made to your IRAs, Coverdell ESAs, or Archer MSAs.

3. You received distributions from Coverdell ESAs in excess of your qualified higher education expenses.

4. You were born before July 1, 1930, and did not take the minimum required distribution from your IRA or other qualified retirement plan.

Exception. If **only** item **1** applies to you **and** distribution code 1 is correctly shown in box 7 of your **Form 1099-R,** you do not have to file Form 5329. Instead, multiply the taxable amount of the distribution by 10% (.10) and enter the result on line 55. The taxable amount of the distribution is the part of the distribution you reported on line 15b or line 16b of Form 1040 or on Form 4972. Also, put "No" under the heading "Other Taxes" to the left of line 55 to indicate that you do not have to file Form 5329. **But** if distribution code 1 is incorrectly shown in box 7 of Form 1099-R, you must file Form 5329.

Line 56

Advance Earned Income Credit Payments

Enter the total amount of advance earned income credit (EIC) payments you received. These payments are shown in box 9 of your W-2 form(s).

Line 57

Household Employment Taxes

If **any** of the following apply, see **Schedule H** and its instructions to find out if you owe these taxes.

1. You paid **any one** household employee (defined below) cash wages of $1,300 or more in 2001. Cash wages include wages paid by checks, money orders, etc.

2. You withheld Federal income tax during 2001 at the request of any household employee.

3. You paid **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2000 or 2001 to household employees.

For item **1,** do not count amounts paid to an employee who was under age 18 at any time in 2001 and was a student.

Household Employee. Any person who does household work is a household employee if you can control what will be done and how it will be done. Household work includes work done in or around your home by babysitters, nannies, health aides, maids, yard workers, and similar domestic workers.

Line 58

Total Tax

Include in the total on line 58 any of the following taxes. To find out if you owe the tax, see the form or publication indicated. On the dotted line next to line 58, enter the amount of the tax and identify it as indicated.

(Continued on page 40)

Need more information or forms? See page 7.

Recapture of the Following Credits.

- Investment credit (see **Form 4255**). Identify as "ICR."
- Low-income housing credit (see **Form 8611**). Identify as "LIHCR."
- Qualified electric vehicle credit (see **Pub. 535**). Identify as "QEVCR."
- Indian employment credit. Identify as "IECR."

Recapture of Federal Mortgage Subsidy. If you sold your home in 2001 and it was financed (in whole or in part) from the proceeds of any tax-exempt qualified mortgage bond or you claimed the mortgage interest credit, see **Form 8828.** Identify as "FMSR."

Section 72(m)(5) Excess Benefits Tax (see **Pub. 560**). Identify as "Sec. 72(m)(5)."

Uncollected Social Security and Medicare or RRTA Tax on Tips or Group-Term Life Insurance. This tax should be shown in box 12 of your Form W-2 with codes **A** and **B** or **M** and **N.** Identify as "UT."

Golden Parachute Payments. If you received an excess parachute payment (EPP), you must pay a 20% tax on it. This tax should be shown in box 12 of your W-2 form with code **K.** If you received a **Form 1099-MISC,** the tax is 20% of the EPP shown in box 13. Identify as "EPP."

Tax on Accumulation Distribution of Trusts. Enter the amount from **Form 4970** and identify as "ADT."

Payments

Line 59

Federal Income Tax Withheld

Add the amounts shown as Federal income tax withheld on your **Forms W-2, W-2G,** and **1099-R.** Enter the total on line 59. The amount withheld should be shown in box 2 of Form W-2 or W-2G, and in box 4 of Form 1099-R. If line 59 includes amounts withheld as shown on Form 1099-R, attach the Form 1099-R to the front of your return.

If you received a 2001 Form 1099 showing Federal income tax withheld on dividends, interest income, unemployment compensation, social security benefits, or other income you received, include the amount withheld in the total on line 59. This should be shown in box 4 of the 1099 form or box 6 of **Form SSA-1099.**

Line 60

2001 Estimated Tax Payments

Enter any payments you made on your estimated Federal income tax **(Form 1040-ES)** for 2001. Include any overpayment from your 2000 return that you applied to your 2001 estimated tax.

If you and your spouse paid joint estimated tax but are now filing separate income tax returns, you can divide the amount paid in any way you choose as long as you both agree. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 2001. For an example of how to do this, see **Pub. 505.** Be sure to show both social security numbers (SSNs) in the space provided on the separate returns. If you or your spouse paid separate estimated tax but you are now filing a joint return, add the amounts you each paid. Follow these instructions even if your spouse died in 2001 or in 2002 before filing a 2001 return.

Divorced Taxpayers

If you got divorced in 2001 and you made joint estimated tax payments with your former spouse, put your former spouse's SSN in the space provided on the front of Form 1040. If you were divorced and remarried in 2001, put your present spouse's SSN in the space provided on the front of Form 1040. Also, under the heading "Payments" to the left of line 60, put your former spouse's SSN, followed by "DIV."

Name Change

If you changed your name because of marriage, divorce, etc., and you made estimated tax payments using your former name, attach a statement to the front of Form 1040. On the statement, explain all the payments you and your spouse made in 2001 and the name(s) and SSN(s) under which you made them.

Lines 61a and 61b— Earned Income Credit (EIC)

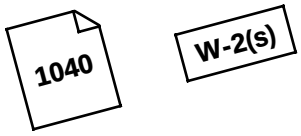
What Is the EIC?

The EIC is a credit for certain people who work. The credit may give you a refund even if you do not owe any tax.

To Take the EIC:

- Follow the steps below.
- Complete the worksheet that applies to you **or** let the IRS figure the credit for you.
- If you have a qualifying child, complete and attach Schedule EIC.

You Will Need:



CAUTION If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. You may also have to pay penalties.

Step 1 All Filers

1. Is the amount on Form 1040, line 34, less than $32,121 (or $10,710 if a child did not live with you in 2001)?

☐ **Yes.** *Continue* ☐ **No.** STOP You cannot take the credit.

2. Do you, and your spouse if filing a joint return, have a social security number that allows you to work or is valid for EIC purposes (see page 44)?

☐ **Yes.** *Continue* ☐ **No.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

3. Is your filing status married filing separately?

☐ **Yes.** STOP You cannot take the credit. ☐ **No.** *Continue*

4. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?

☐ **Yes.** STOP You cannot take the credit. ☐ **No.** *Continue*

5. Were you a nonresident alien for any part of 2001?

☐ **Yes.** *See Nonresident Aliens on page 44.* ☐ **No.** *Go to Step 2.*

Step 2 Investment Income

1. Add the amounts from Form 1040:

Line 8a _____
Line 8b + _____
Line 9 + _____
Line 13 + _____
Investment Income = _____

2. Is your investment income more than $2,450?

☐ **Yes.** *Continue* ☐ **No.** *Skip the next question; go to Step 3.*

3. Are you filing Form 4797 (relating to sales of business property)?

☐ **Yes.** *See Form 4797 Filers on page 44.* ☐ **No.** STOP You cannot take the credit.

Step 3 Who Must Use Pub. 596

Some people must use Pub. 596, Earned Income Credit, to see if they can take the credit and how to figure it. To see if you must use Pub. 596, answer the following questions.

1. Are you filing Schedule E?

☐ **No.** *Continue* ☐ **Yes.** →

2. Are you claiming a loss on Form 1040, line 12, 13, or 18?

☐ **No.** *Continue* ☐ **Yes.** →

3. Are you reporting income or a loss from the rental of personal property not used in a trade or business?

☐ **No.** *Continue* ☐ **Yes.** →

4. Did you, or your spouse if filing a joint return, receive a distribution from a pension, annuity, IRA, or Coverdell ESA that is not fully taxable?

☐ **No.** *Continue* ☐ **Yes.** →

5. Are you reporting income on Form 1040, line 21, from Form 8814 (relating to election to report child's interest and dividends)?

☐ **No.** *Continue* ☐ **Yes.** →

6. Did you enter an amount other than zero on Form 1040, line 41?

☐ **No.** *Continue* ☐ **Yes.** →

STOP You must use Pub. 596 to see if you can take the credit and how to figure it.

To get Pub. 596, see page 7.

7. Did a child live with you in 2001?

☐ **Yes.** *Go to Step 4 on page 42.* ☐ **No.** *Go to Step 5 on page 42.*

Need more information or forms? See page 7.

Continued from page 41

Step 4 Qualifying Child

A qualifying child is a child who is your...

Son	Grandchild
Daughter	Stepchild
Adopted child	Foster child (see page 44)

If the child was married, see page 44.

AND

was at the end of 2001...

Under age 19

or

Under age 24 and a student (see page 44)

or

Any age and permanently and totally disabled (see page 44)

AND

who...

Lived with you in the United States for more than half of 2001 or, if a foster child, for all of 2001. If the child did not live with you for the required time, see Exception to "Time Lived With You" Condition on page 44.

1. Look at the qualifying child conditions above. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2001?

☐ **Yes.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

☐ **No.** *Continue*

2. Do you have at least one child who meets the above conditions to be your qualifying child?

☐ **Yes.** *Continue*

☐ **No.** *Skip the next question; go to Step 5, question 2.*

3. Does the child meet the conditions to be a qualifying child of any other person (other than your spouse if filing a joint return) for 2001?

☐ **Yes.** *See Qualifying Child of More Than One Person on page 44.*

☐ **No.** This child is your qualifying child. The child must have a social security number as defined on page 44 unless the child was born and died in 2001. *Skip Step 5; go to Step 6.*

Step 5 Filers Without a Qualifying Child

1. Look at the qualifying child conditions in Step 4. Could you, or your spouse if filing a joint return, be a qualifying child of another person in 2001?

☐ **Yes.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

☐ **No.** *Continue*

2. Can you, or your spouse if filing a joint return, be claimed as a dependent on someone else's 2001 tax return?

☐ **Yes.** STOP You cannot take the credit.

☐ **No.** *Continue*

3. Were you, or your spouse if filing a joint return, at least age 25 but under age 65 at the end of 2001?

☐ **Yes.** *Continue*

☐ **No.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

4. Was your home, and your spouse's if filing a joint return, in the United States for more than half of 2001? Members of the military stationed outside the United States, see page 44 before you answer.

☐ **Yes.** *Go to Step 6.*

☐ **No.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

Step 6 Modified Adjusted Gross Income

1. Add the amounts from Form 1040:

Line 8b _____

Line 34 + _____

Modified Adjusted Gross Income = Box A

2. If you have:

- 2 or more qualifying children, is Box A less than $32,121?
- 1 qualifying child, is Box A less than $28,281?
- No qualifying children, is Box A less than $10,710?

☐ **Yes.** *Go to Step 7 on page 43.*

☐ **No.** STOP You cannot take the credit.

(Continued on page 43)

Continued from page 42

Step 7 Nontaxable and Taxable Earned Income

1. Add all your nontaxable earned income, including your spouse's if filing a joint return. This includes anything of value (money, goods, or services) that is not taxable that you received from your employer for your work. Types of nontaxable earned income are listed below.

- Salary deferrals, such as a 401(k) plan or the Federal Thrift Savings Plan, shown in box 12 of your W-2 form. See page 44.
- Salary reductions, such as under a cafeteria plan, unless they are included in box 1 of your W-2 form. See page 44.
- Mandatory contributions to a state or local retirement plan.
- Military employee basic housing, subsistence, and combat zone compensation. These amounts are shown in box 12 of your W-2 form with code Q.
- Meals and lodging provided for the convenience of your employer.
- Housing allowances or rental value of a parsonage for clergy members. If filing Schedule SE, see Clergy on this page.
- Excludable dependent care benefits from Form 2441, line 18, employer-provided adoption benefits from Form 8839, line 26, and educational assistance benefits (these benefits may be shown in box 14 of your W-2 form).
- Certain amounts received by Native Americans. See Pub. 596.

Note. Nontaxable earned income does not include welfare benefits or workfare payments (see page 44), or qualified foster care payments.

Nontaxable Earned Income = Box B _____

Enter this amount on Form 1040, line 61b. 

2. Are you filing Schedule SE because you had church employee income of $108.28 or more?

☐ **Yes.** *See Church Employees on this page.* ☐ **No.** *Continue*

3. Figure taxable earned income:

Form 1040, line 7 _____

Subtract, if included on line 7, any:

- Taxable scholarship or fellowship grant not reported on a W-2 form
- Amount paid to an inmate in a penal institution for work (put "PRI" and the amount subtracted on the dotted line next to line 7 of Form 1040)
- Amount received as a pension or annuity from a nonqualified deferred compensation plan or a section 457 plan (put "DFC" and the amount subtracted on the dotted line next to line 7 of Form 1040). This amount may be shown in box 11 of your W-2 form. If you received such an amount but box 11 is blank, contact your employer for the amount received as a pension or annuity.

– _____

Taxable Earned Income = Box C _____

Go to question 4.

4. Were you self-employed, or are you filing Schedule SE because you had church employee income, or are you filing Schedule C or C-EZ as a statutory employee?

☐ **Yes.** *Skip Steps 8 and 9; go to Worksheet B on page 46.* ☐ **No.** *Go to Step 8.*

Step 8 Total Earned Income

1. Nontaxable Earned Income (Step 7, Box B) _____

Taxable Earned Income (Step 7, Box C) + _____

Total Earned Income = Box D _____

2. If you have:

- 2 or more qualifying children, is Box D less than $32,121?
- 1 qualifying child, is Box D less than $28,281?
- No qualifying children, is Box D less than $10,710?

☐ **Yes.** *Go to Step 9.* ☐ **No.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

Step 9 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?

☐ **Yes.** *See Credit Figured by the IRS below.* ☐ **No.** *Go to Worksheet A on page 45.*

Definitions and Special Rules *(listed in alphabetical order)*

Adopted Child. Any child placed with you by an authorized placement agency for legal adoption. An authorized placement agency includes any person authorized by state law to place children for legal adoption. The adoption does not have to be final.

Church Employees. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 5a. Subtract that amount from the amount on Form 1040, line 7, and enter the result in the first space of Step 7, line 3. Be sure to answer "Yes" on line 4 of Step 7.

Clergy. If you are filing Schedule SE and the amount on line 2 of that schedule includes an amount that was also reported on Form 1040, line 7:

1. Put "Clergy" directly to the right of line 61a of Form 1040.
2. Do not include any housing allowance or rental value of the parsonage as nontaxable earned income in Box B if it is required to be included on Schedule SE, line 2.
3. Determine how much of the amount on Form 1040, line 7, was also reported on Schedule SE, line 2.
4. Subtract that amount from the amount on Form 1040, line 7. Enter the result in the first space of Step 7, line 3.
5. Be sure to answer "Yes" on line 4 of Step 7.

Credit Figured by the IRS. To have the IRS figure the credit for you:

1. Put "EIC" directly to the right of line 61a of Form 1040.
2. Be sure you entered the amount of any nontaxable earned income (Step 7, Box B, on this page) on Form 1040, line 61b.

(Continued on page 44)

Continued from page 43

3. If you have a qualifying child, complete and attach Schedule EIC. If your EIC for a year after 1996 was reduced or disallowed, see Form 8862, Who Must File, below.

Exception to "Time Lived With You" Condition. A child is considered to have lived with you for all of 2001 if the child was born or died in 2001 and your home was this child's home for the entire time he or she was alive in 2001. Temporary absences, such as for school, vacation, medical care, or detention in a juvenile facility, count as time lived at home. If your child is presumed to have been kidnapped by someone who is not a family member, see Pub. 596 to find out if that child is a qualifying child for the EIC. To get Pub. 596, see page 7. If you were in the military stationed outside the United States, see Members of the Military below.

Form 4797 Filers. If the amount on Form 1040, line 13, includes an amount from Form 4797, you must use Pub. 596 to see if you can take the EIC and how to figure it. To get Pub. 596, see page 7. Otherwise, stop; you cannot take the EIC.

Form 8862, Who Must File. You must file Form 8862 if your EIC for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 if, after your EIC was reduced or disallowed in an earlier year:

- You filed Form 8862 (or other documents) and your EIC was then allowed and
- Your EIC has not been reduced or disallowed again for any reason other than a math or clerical error.

Also, do not file Form 8862 or take the credit if it was determined that your error was due to reckless or intentional disregard of the EIC rules or fraud.

Foster Child. Any child you cared for as your own child **and** who is **(a)** your brother, sister, stepbrother, or stepsister; **(b)** a descendant (such as a child, including an adopted child) of your brother, sister, stepbrother, or stepsister; or **(c)** a child placed with you by an authorized placement agency. For example, if you acted as the parent of your niece or nephew, this child is considered your foster child.

Grandchild. Any descendant of your son, daughter, or adopted child. For example, a grandchild includes your great-grandchild, great-great-grandchild, etc.

Married Child. A child who was married at the end of 2001 is a qualifying child only if **(a)** you can claim him or her as your dependent on Form 1040, line 6c, or **(b)** this child's other parent claims him or her as a dependent under the rules in Pub. 501 for children of divorced or separated parents.

Members of the Military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you serve fewer than 90 days.

Nonresident Aliens. If your filing status is married filing jointly, go to Step 2 on page 41. Otherwise, stop; you cannot take the EIC.

Permanently and Totally Disabled Child. A child who cannot engage in any substantial gainful activity because of a physical or mental condition and a doctor has determined that this condition:

- Has lasted or can be expected to last continuously for at least a year or
- Can lead to death.

Qualifying Child of More Than One Person. If the child meets the conditions to be a qualifying child of more than one person, only the person who had the **highest** modified adjusted gross income (AGI) for 2001 may treat that child as a qualifying child. The other person(s) cannot take the EIC for people who do not have a qualifying child. If the other person is your spouse and you are filing a joint return, this rule does not apply. If you have the highest modified AGI, this child is your qualifying child. The child must have a social security number as defined below unless the child was born and died in 2001. Skip Step 5; go to Step 6 on page 42. If you do not have the highest modified AGI, stop; you cannot take the EIC. Put "No" directly to the right of line 61a.

Modified AGI is the total of the amounts on Form 1040, lines 8b and 34, increased by:

- Any loss claimed on Form 1040, line 13,
- Any loss from the rental of personal property not used in a trade or business,
- 75% of any losses on Form 1040, lines 12 and 18,
- Certain nontaxable distributions from a pension, annuity, or IRA (see Pub. 596), and
- Certain amounts reported on Schedule E (see Pub. 596).

Example. You and your 5-year-old daughter moved in with your mother in April 2001. You are not a qualifying child of your mother. Your daughter meets the conditions to be a qualifying child for both you and your mother. Your modified AGI for 2001 was $8,000 and your mother's was $14,000. Because your mother's modified AGI was higher, your daughter is your mother's qualifying child. You **cannot** take any EIC even if your mother does not claim the credit. You would put "No" directly to the right of line 61a.

Salary Deferrals. Contributions from your pay to certain retirement plans, such as a 401(k) plan or the Federal Thrift Savings Plan, shown in box 12 of your W-2 form. The "Retirement plan" box in box 13 of your W-2 form should be checked.

Salary Reductions. Amounts you could have been paid but chose instead to have your employer contribute to certain benefit plans, such as a cafeteria plan. A cafeteria plan is a plan that allows you to choose to receive either cash or certain benefits that are not taxed (such as accident and health insurance).

Social Security Number (SSN). For purposes of taking the EIC, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a Federally funded benefit.

To find out how to get an SSN, see page 19. If you will not have an SSN by April 15, 2002, see What if You Cannot File on Time? on page 15.

Student. A child who during any 5 months of 2001:

- Was enrolled as a full-time student at a school or
- Took a full-time, on-farm training course given by a school or a state, county, or local government agency.

A **school** includes technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or night schools.

Welfare Benefits, Effect of Credit on. Any refund you receive as a result of taking the EIC will not be used to determine if you are eligible for the following programs, or how much you can receive from them.

- Temporary Assistance for Needy Families (TANF).
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

Workfare Payments. Cash payments certain people receive from a state or local agency that administers public assistance programs funded under the Federal Temporary Assistance for Needy Families (TANF) program in return for certain work activities such as:

- Work experience activities (including work associated with remodeling or repairing publicly assisted housing) if sufficient private sector employment is not available or
- Community service program activities.

Worksheet A—Earned Income Credit (EIC)—Lines 61a and 61b

Keep for Your Records

Before you begin: √ Be sure you are using the correct worksheet. **Do not** use this worksheet if you were self-employed, or you are filing Schedule SE because you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee. Instead, use Worksheet B on page 46.

Part 1

All Filers Using Worksheet A

1. Enter your total earned income from Step 8, Box D, on page 43. | **1** |

2. Look up the amount on line 1 above in the EIC Table on pages 48–50 to find the credit. Enter the credit here. | **2** |

If line 2 is zero, STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

3. Enter your modified adjusted gross income from Step 6, Box A, on page 42. | **3** |

4. Are the amounts on lines 3 and 1 the same?

☐ **Yes.** *Skip line 5; enter the amount from line 2 on line 6.*

☐ **No.** *Go to line 5.*

Part 2

Filers Who Answered "No" on Line 4

5. Is the amount on line 3 less than:

- $5,950 if you do not have a qualifying child **or**
- $13,100 if you have one or more qualifying children?

☐ **Yes.** *Leave line 5 blank; enter the amount from line 2 on line 6.*

☐ **No.** Look up the amount on line 3 in the EIC Table on pages 48–50 to find the credit. Enter the credit here. | **5** |

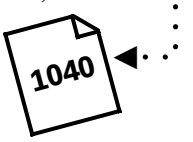
*Look at the amounts on lines 5 and 2. Then, enter the **smaller** amount on line 6.*

Part 3

Your Earned Income Credit

6. **This is your earned income credit.** | **6** |

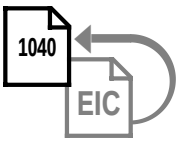
Enter this amount on Form 1040, line 61a.



Reminder—

√ Be sure you entered the amount of any nontaxable earned income (Step 7, Box B, on page 43) on Form 1040, line 61b.

√ If you have a qualifying child, complete and attach Schedule EIC.



CAUTION If your EIC for a year after 1996 was reduced or disallowed, see page 44 to find out if you must file Form 8862 to take the credit for 2001.

Need more information or forms? See page 7.

Worksheet B—Earned Income Credit (EIC)—Lines 61a and 61b

Keep for Your Records

Use this worksheet if you were self-employed, or you are filing Schedule SE because you had church employee income, or you are filing Schedule C or C-EZ as a statutory employee.

√ Complete the parts below (Parts 1 through 3) that apply to you. Then, continue to Part 4.

√ If you are married filing a joint return, include your spouse's amounts, if any, with yours to figure the amounts to enter in Parts 1 through 3.

Part 1

Self-Employed and People With Church Employee Income Filing Schedule SE

1a.	Enter the amount from Schedule SE, Section A, line 3, or Section B, line 3, whichever applies.		**1a**	
b.	Enter any amount from Schedule SE, Section B, line 4b, and line 5a.	+	**1b**	
c.	Add lines 1a and 1b.	=	**1c**	
d.	Enter the amount from Schedule SE, Section A, line 6, or Section B, line 13, whichever applies.	–	**1d**	
e.	Subtract line 1d from 1c.	=	**1e**	

Part 2

Self-Employed NOT Required To File Schedule SE

For example, your net earnings from self-employment were less than $400.

2. Do not include on these lines any statutory employee income or any amount exempt from self-employment tax as the result of the filing and approval of Form 4029 or Form 4361.

a.	Enter any net farm profit or (loss) from Schedule F, line 36, and from farm partnerships, Schedule K-1 (Form 1065), line 15a*.		**2a**	
b.	Enter any net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9*.	+	**2b**	
c.	Add lines 2a and 2b.	=	**2c**	

*If you have any Schedule K-1 amounts, complete the appropriate line(s) of Schedule SE, Section A. Put your name and social security number on Schedule SE and attach it to your return.

Part 3

Statutory Employees Filing Schedule C or C-EZ

3. Enter the amount from Schedule C, line 1, or Schedule C-EZ, line 1, that you are filing as a statutory employee. **3**

Part 4

All Filers Using Worksheet B

Note. If line 4d includes income on which you should have paid self-employment tax but did not, we may reduce your credit by the amount of self-employment tax not paid.

4a.	Add lines 1e, 2c, and 3.		**4a**	
b.	Enter your nontaxable earned income from Step 7, Box B, on page 43.	+	**4b**	
c.	Enter your taxable earned income from Step 7, Box C, on page 43.	+	**4c**	
d.	Add lines 4a, 4b, and 4c. **This is your total earned income.**	=	**4d**	

5. If you have:

- 2 or more qualifying children, is line 4d less than $32,121?
- 1 qualifying child, is line 4d less than $28,281?
- No qualifying children, is line 4d less than $10,710?

☐ **Yes.** If you want the IRS to figure your credit, see page 43. *If you want to figure the credit yourself, enter the amount from line 4d on line 6 (page 47).*

☐ **No.** STOP You cannot take the credit. *Put "No" directly to the right of line 61a.*

(Continued on page 47)

Worksheet B—*Continued from page 46*

Keep for Your Records

Part 5

All Filers Using Worksheet B

6. Enter your total earned income from Part 4, line 4d, on page 46. | **6** |

7. Look up the amount on line 6 above in the EIC Table on pages 48–50 to find the credit. Enter the credit here. | **7** |

If line 7 is zero, STOP You cannot take the credit.
Put "No" directly to the right of line 61a.

8. Enter your modified adjusted gross income from Step 6, Box A, on page 42. | **8** |

9. Are the amounts on lines 8 and 6 the same?

☐ **Yes.** *Skip line 10; enter the amount from line 7 on line 11.*

☐ **No.** *Go to line 10.*

10. Is the amount on line 8 less than:

- $5,950 if you do not have a qualifying child **or**
- $13,100 if you have one or more qualifying children?

☐ **Yes.** *Leave line 10 blank; enter the amount from line 7 on line 11.*

☐ **No.** Look up the amount on line 8 in the EIC Table on pages 48–50 to find the credit. Enter the credit here. | **10** |

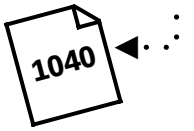
*Look at the amounts on lines 10 and 7. Then, enter the **smaller** amount on line 11.*

Part 6

Your Earned Income Credit

11. **This is your earned income credit.** | **11** |

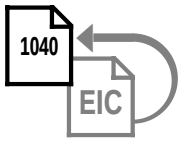
Enter this amount on Form 1040, line 61a.



Reminder—

√ Be sure you entered the amount of any nontaxable earned income (Step 7, Box B, on page 43) on Form 1040, line 61b.

√ If you have a qualifying child, complete and attach Schedule EIC.



CAUTION If your EIC for a year after 1996 was reduced or disallowed, see page 44 to find out if you must file Form 8862 to take the credit for 2001.

2001 Earned Income Credit (EIC) Table

CAUTION

This is **not** a tax table.

1. To find your credit, read down the "At least – But less than" columns and find the line that includes the amount you were told to look up from your EIC Worksheet.

2. Then, read across to the column that includes the number of qualifying children you have. Enter the credit from that column on your EIC Worksheet.

Example. If you have one qualifying child and the amount you are looking up from your EIC Worksheet is $4,875, you would enter $1,658.

If the amount you are looking up from the worksheet is—		And you have—		
		No children	One child	Two children
At least	But less than	Your credit is—		
4,800	4,850	364	1,641	1,930
4,850	4,900	364	1,658	1,950
4,900	4,950	364	1,675	1,970
4,950	5,000	364	1,692	1,990

If the amount you are looking up from the worksheet is—		And you have—		
		No children	One child	Two children
At least	But less than	Your credit is—		
$1	$50	$2	$9	$10
50	100	6	26	30
100	150	10	43	50
150	200	13	60	70
200	250	17	77	90
250	300	21	94	110
300	350	25	111	130
350	400	29	128	150
400	450	33	145	170
450	500	36	162	190
500	550	40	179	210
550	600	44	196	230
600	650	48	213	250
650	700	52	230	270
700	750	55	247	290
750	800	59	264	310
800	850	63	281	330
850	900	67	298	350
900	950	71	315	370
950	1,000	75	332	390
1,000	1,050	78	349	410
1,050	1,100	82	366	430
1,100	1,150	86	383	450
1,150	1,200	90	400	470
1,200	1,250	94	417	490
1,250	1,300	98	434	510
1,300	1,350	101	451	530
1,350	1,400	105	468	550
1,400	1,450	109	485	570
1,450	1,500	113	502	590
1,500	1,550	117	519	610
1,550	1,600	120	536	630
1,600	1,650	124	553	650
1,650	1,700	128	570	670
1,700	1,750	132	587	690
1,750	1,800	136	604	710
1,800	1,850	140	621	730
1,850	1,900	143	638	750
1,900	1,950	147	655	770
1,950	2,000	151	672	790
2,000	2,050	155	689	810
2,050	2,100	159	706	830
2,100	2,150	163	723	850
2,150	2,200	166	740	870
2,200	2,250	170	757	890
2,250	2,300	174	774	910
2,300	2,350	178	791	930
2,350	2,400	182	808	950
2,400	2,450	186	825	970
2,450	2,500	189	842	990
2,500	2,550	193	859	1,010
2,550	2,600	197	876	1,030
2,600	2,650	201	893	1,050
2,650	2,700	205	910	1,070
2,700	2,750	208	927	1,090
2,750	2,800	212	944	1,110
2,800	2,850	216	961	1,130
2,850	2,900	220	978	1,150
2,900	2,950	224	995	1,170
2,950	3,000	228	1,012	1,190
3,000	3,050	231	1,029	1,210
3,050	3,100	235	1,046	1,230
3,100	3,150	239	1,063	1,250
3,150	3,200	243	1,080	1,270
3,200	3,250	247	1,097	1,290
3,250	3,300	251	1,114	1,310
3,300	3,350	254	1,131	1,330
3,350	3,400	258	1,148	1,350
3,400	3,450	262	1,165	1,370
3,450	3,500	266	1,182	1,390
3,500	3,550	270	1,199	1,410
3,550	3,600	273	1,216	1,430
3,600	3,650	277	1,233	1,450
3,650	3,700	281	1,250	1,470
3,700	3,750	285	1,267	1,490
3,750	3,800	289	1,284	1,510
3,800	3,850	293	1,301	1,530
3,850	3,900	296	1,318	1,550
3,900	3,950	300	1,335	1,570
3,950	4,000	304	1,352	1,590
4,000	4,050	308	1,369	1,610
4,050	4,100	312	1,386	1,630
4,100	4,150	316	1,403	1,650
4,150	4,200	319	1,420	1,670
4,200	4,250	323	1,437	1,690
4,250	4,300	327	1,454	1,710
4,300	4,350	331	1,471	1,730
4,350	4,400	335	1,488	1,750
4,400	4,450	339	1,505	1,770
4,450	4,500	342	1,522	1,790
4,500	4,550	346	1,539	1,810
4,550	4,600	350	1,556	1,830
4,600	4,650	354	1,573	1,850
4,650	4,700	358	1,590	1,870
4,700	4,750	361	1,607	1,890
4,750	4,800	364	1,624	1,910
4,800	4,850	364	1,641	1,930
4,850	4,900	364	1,658	1,950
4,900	4,950	364	1,675	1,970
4,950	5,000	364	1,692	1,990
5,000	5,050	364	1,709	2,010
5,050	5,100	364	1,726	2,030
5,100	5,150	364	1,743	2,050
5,150	5,200	364	1,760	2,070
5,200	5,250	364	1,777	2,090
5,250	5,300	364	1,794	2,110
5,300	5,350	364	1,811	2,130
5,350	5,400	364	1,828	2,150
5,400	5,450	364	1,845	2,170
5,450	5,500	364	1,862	2,190
5,500	5,550	364	1,879	2,210
5,550	5,600	364	1,896	2,230
5,600	5,650	364	1,913	2,250
5,650	5,700	364	1,930	2,270
5,700	5,750	364	1,947	2,290
5,750	5,800	364	1,964	2,310
5,800	5,850	364	1,981	2,330
5,850	5,900	364	1,998	2,350
5,900	5,950	364	2,015	2,370
5,950	6,000	362	2,032	2,390
6,000	6,050	358	2,049	2,410
6,050	6,100	355	2,066	2,430
6,100	6,150	351	2,083	2,450
6,150	6,200	347	2,100	2,470
6,200	6,250	343	2,117	2,490
6,250	6,300	339	2,134	2,510
6,300	6,350	335	2,151	2,530
6,350	6,400	332	2,168	2,550
6,400	6,450	328	2,185	2,570
6,450	6,500	324	2,202	2,590
6,500	6,550	320	2,219	2,610
6,550	6,600	316	2,236	2,630
6,600	6,650	313	2,253	2,650
6,650	6,700	309	2,270	2,670
6,700	6,750	305	2,287	2,690
6,750	6,800	301	2,304	2,710
6,800	6,850	297	2,321	2,730
6,850	6,900	293	2,338	2,750
6,900	6,950	290	2,355	2,770
6,950	7,000	286	2,372	2,790
7,000	7,050	282	2,389	2,810
7,050	7,100	278	2,406	2,830
7,100	7,150	274	2,428	2,850
7,150	7,200	270	2,428	2,870
7,200	7,250	267	2,428	2,890
7,250	7,300	263	2,428	2,910
7,300	7,350	259	2,428	2,930
7,350	7,400	255	2,428	2,950
7,400	7,450	251	2,428	2,970
7,450	7,500	247	2,428	2,990
7,500	7,550	244	2,428	3,010
7,550	7,600	240	2,428	3,030
7,600	7,650	236	2,428	3,050
7,650	7,700	232	2,428	3,070
7,700	7,750	228	2,428	3,090
7,750	7,800	225	2,428	3,110
7,800	7,850	221	2,428	3,130
7,850	7,900	217	2,428	3,150
7,900	7,950	213	2,428	3,170
7,950	8,000	209	2,428	3,190
8,000	8,050	205	2,428	3,210
8,050	8,100	202	2,428	3,230
8,100	8,150	198	2,428	3,250
8,150	8,200	194	2,428	3,270
8,200	8,250	190	2,428	3,290
8,250	8,300	186	2,428	3,310
8,300	8,350	182	2,428	3,330
8,350	8,400	179	2,428	3,350
8,400	8,450	175	2,428	3,370
8,450	8,500	171	2,428	3,390
8,500	8,550	167	2,428	3,410
8,550	8,600	163	2,428	3,430
8,600	8,650	160	2,428	3,450
8,650	8,700	156	2,428	3,470
8,700	8,750	152	2,428	3,490
8,750	8,800	148	2,428	3,510

(Continued on page 49)

2001 Earned Income Credit (EIC) Table *Continued* (**Caution.** This is **not** a tax table.)

If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—		
		No children	One child	Two children			No children	One child	Two children			No children	One child	Two children			No children	One child	Two children
At least	But less than	Your credit is—			At least	But less than	Your credit is—			At least	But less than	Your credit is—			At least	But less than	Your credit is—		
8,800	**8,850**	144	2,428	3,530	**13,900**	**13,950**	0	2,294	3,832	**16,700**	**16,750**	0	1,847	3,242	**19,500**	**19,550**	0	1,399	2,653
8,850	**8,900**	140	2,428	3,550	**13,950**	**14,000**	0	2,286	3,822	**16,750**	**16,800**	0	1,839	3,232	**19,550**	**19,600**	0	1,391	2,642
8,900	**8,950**	137	2,428	3,570	**14,000**	**14,050**	0	2,278	3,811	**16,800**	**16,850**	0	1,831	3,221	**19,600**	**19,650**	0	1,383	2,632
8,950	**9,000**	133	2,428	3,590	**14,050**	**14,100**	0	2,270	3,801	**16,850**	**16,900**	0	1,823	3,211	**19,650**	**19,700**	0	1,375	2,621
9,000	**9,050**	129	2,428	3,610	**14,100**	**14,150**	0	2,262	3,790	**16,900**	**16,950**	0	1,815	3,200	**19,700**	**19,750**	0	1,367	2,611
9,050	**9,100**	125	2,428	3,630	**14,150**	**14,200**	0	2,254	3,779	**16,950**	**17,000**	0	1,807	3,190	**19,750**	**19,800**	0	1,359	2,600
9,100	**9,150**	121	2,428	3,650	**14,200**	**14,250**	0	2,246	3,769	**17,000**	**17,050**	0	1,799	3,179	**19,800**	**19,850**	0	1,351	2,590
9,150	**9,200**	117	2,428	3,670	**14,250**	**14,300**	0	2,238	3,758	**17,050**	**17,100**	0	1,791	3,169	**19,850**	**19,900**	0	1,343	2,579
9,200	**9,250**	114	2,428	3,690	**14,300**	**14,350**	0	2,230	3,748	**17,100**	**17,150**	0	1,783	3,158	**19,900**	**19,950**	0	1,335	2,569
9,250	**9,300**	110	2,428	3,710	**14,350**	**14,400**	0	2,222	3,737	**17,150**	**17,200**	0	1,775	3,148	**19,950**	**20,000**	0	1,327	2,558
9,300	**9,350**	106	2,428	3,730	**14,400**	**14,450**	0	2,214	3,727	**17,200**	**17,250**	0	1,767	3,137	**20,000**	**20,050**	0	1,319	2,547
9,350	**9,400**	102	2,428	3,750	**14,450**	**14,500**	0	2,206	3,716	**17,250**	**17,300**	0	1,759	3,127	**20,050**	**20,100**	0	1,311	2,537
9,400	**9,450**	98	2,428	3,770	**14,500**	**14,550**	0	2,198	3,706	**17,300**	**17,350**	0	1,751	3,116	**20,100**	**20,150**	0	1,303	2,526
9,450	**9,500**	94	2,428	3,790	**14,550**	**14,600**	0	2,190	3,695	**17,350**	**17,400**	0	1,743	3,106	**20,150**	**20,200**	0	1,295	2,516
9,500	**9,550**	91	2,428	3,810	**14,600**	**14,650**	0	2,182	3,685	**17,400**	**17,450**	0	1,735	3,095	**20,200**	**20,250**	0	1,287	2,505
9,550	**9,600**	87	2,428	3,830	**14,650**	**14,700**	0	2,174	3,674	**17,450**	**17,500**	0	1,727	3,085	**20,250**	**20,300**	0	1,279	2,495
9,600	**9,650**	83	2,428	3,850	**14,700**	**14,750**	0	2,166	3,664	**17,500**	**17,550**	0	1,719	3,074	**20,300**	**20,350**	0	1,271	2,484
9,650	**9,700**	79	2,428	3,870	**14,750**	**14,800**	0	2,158	3,653	**17,550**	**17,600**	0	1,711	3,063	**20,350**	**20,400**	0	1,263	2,474
9,700	**9,750**	75	2,428	3,890	**14,800**	**14,850**	0	2,150	3,643	**17,600**	**17,650**	0	1,703	3,053	**20,400**	**20,450**	0	1,255	2,463
9,750	**9,800**	72	2,428	3,910	**14,850**	**14,900**	0	2,142	3,632	**17,650**	**17,700**	0	1,695	3,042	**20,450**	**20,500**	0	1,247	2,453
9,800	**9,850**	68	2,428	3,930	**14,900**	**14,950**	0	2,134	3,622	**17,700**	**17,750**	0	1,687	3,032	**20,500**	**20,550**	0	1,239	2,442
9,850	**9,900**	64	2,428	3,950	**14,950**	**15,000**	0	2,126	3,611	**17,750**	**17,800**	0	1,679	3,021	**20,550**	**20,600**	0	1,231	2,432
9,900	**9,950**	60	2,428	3,970	**15,000**	**15,050**	0	2,118	3,600	**17,800**	**17,850**	0	1,671	3,011	**20,600**	**20,650**	0	1,224	2,421
9,950	**10,000**	56	2,428	3,990	**15,050**	**15,100**	0	2,110	3,590	**17,850**	**17,900**	0	1,663	3,000	**20,650**	**20,700**	0	1,216	2,411
10,000	**10,050**	52	2,428	4,008	**15,100**	**15,150**	0	2,102	3,579	**17,900**	**17,950**	0	1,655	2,990	**20,700**	**20,750**	0	1,208	2,400
10,050	**10,100**	49	2,428	4,008	**15,150**	**15,200**	0	2,094	3,569	**17,950**	**18,000**	0	1,647	2,979	**20,750**	**20,800**	0	1,200	2,390
10,100	**10,150**	45	2,428	4,008	**15,200**	**15,250**	0	2,086	3,558	**18,000**	**18,050**	0	1,639	2,969	**20,800**	**20,850**	0	1,192	2,379
10,150	**10,200**	41	2,428	4,008	**15,250**	**15,300**	0	2,078	3,548	**18,050**	**18,100**	0	1,631	2,958	**20,850**	**20,900**	0	1,184	2,368
10,200	**10,250**	37	2,428	4,008	**15,300**	**15,350**	0	2,070	3,537	**18,100**	**18,150**	0	1,623	2,948	**20,900**	**20,950**	0	1,176	2,358
10,250	**10,300**	33	2,428	4,008	**15,350**	**15,400**	0	2,062	3,527	**18,150**	**18,200**	0	1,615	2,937	**20,950**	**21,000**	0	1,168	2,347
10,300	**10,350**	29	2,428	4,008	**15,400**	**15,450**	0	2,054	3,516	**18,200**	**18,250**	0	1,607	2,927	**21,000**	**21,050**	0	1,160	2,337
10,350	**10,400**	26	2,428	4,008	**15,450**	**15,500**	0	2,046	3,506	**18,250**	**18,300**	0	1,599	2,916	**21,050**	**21,100**	0	1,152	2,326
10,400	**10,450**	22	2,428	4,008	**15,500**	**15,550**	0	2,038	3,495	**18,300**	**18,350**	0	1,591	2,906	**21,100**	**21,150**	0	1,144	2,316
10,450	**10,500**	18	2,428	4,008	**15,550**	**15,600**	0	2,030	3,485	**18,350**	**18,400**	0	1,583	2,895	**21,150**	**21,200**	0	1,136	2,305
10,500	**10,550**	14	2,428	4,008	**15,600**	**15,650**	0	2,023	3,474	**18,400**	**18,450**	0	1,575	2,884	**21,200**	**21,250**	0	1,128	2,295
10,550	**10,600**	10	2,428	4,008	**15,650**	**15,700**	0	2,015	3,464	**18,450**	**18,500**	0	1,567	2,874	**21,250**	**21,300**	0	1,120	2,284
10,600	**10,650**	7	2,428	4,008	**15,700**	**15,750**	0	2,007	3,453	**18,500**	**18,550**	0	1,559	2,863	**21,300**	**21,350**	0	1,112	2,274
10,650	**10,700**	3	2,428	4,008	**15,750**	**15,800**	0	1,999	3,443	**18,550**	**18,600**	0	1,551	2,853	**21,350**	**21,400**	0	1,104	2,263
10,700	**10,750**	*	2,428	4,008	**15,800**	**15,850**	0	1,991	3,432	**18,600**	**18,650**	0	1,543	2,842	**21,400**	**21,450**	0	1,096	2,253
10,750	**13,100**	0	2,428	4,008	**15,850**	**15,900**	0	1,983	3,421	**18,650**	**18,700**	0	1,535	2,832	**21,450**	**21,500**	0	1,088	2,242
13,100	**13,150**	0	2,422	4,001	**15,900**	**15,950**	0	1,975	3,411	**18,700**	**18,750**	0	1,527	2,821	**21,500**	**21,550**	0	1,080	2,232
13,150	**13,200**	0	2,414	3,990	**15,950**	**16,000**	0	1,967	3,400	**18,750**	**18,800**	0	1,519	2,811	**21,550**	**21,600**	0	1,072	2,221
13,200	**13,250**	0	2,406	3,980	**16,000**	**16,050**	0	1,959	3,390	**18,800**	**18,850**	0	1,511	2,800	**21,600**	**21,650**	0	1,064	2,211
13,250	**13,300**	0	2,398	3,969	**16,050**	**16,100**	0	1,951	3,379	**18,850**	**18,900**	0	1,503	2,790	**21,650**	**21,700**	0	1,056	2,200
13,300	**13,350**	0	2,390	3,959	**16,100**	**16,150**	0	1,943	3,369	**18,900**	**18,950**	0	1,495	2,779	**21,700**	**21,750**	0	1,048	2,189
13,350	**13,400**	0	2,382	3,948	**16,150**	**16,200**	0	1,935	3,358	**18,950**	**19,000**	0	1,487	2,769	**21,750**	**21,800**	0	1,040	2,179
13,400	**13,450**	0	2,374	3,937	**16,200**	**16,250**	0	1,927	3,348	**19,000**	**19,050**	0	1,479	2,758	**21,800**	**21,850**	0	1,032	2,168
13,450	**13,500**	0	2,366	3,927	**16,250**	**16,300**	0	1,919	3,337	**19,050**	**19,100**	0	1,471	2,748	**21,850**	**21,900**	0	1,024	2,158
13,500	**13,550**	0	2,358	3,916	**16,300**	**16,350**	0	1,911	3,327	**19,100**	**19,150**	0	1,463	2,737	**21,900**	**21,950**	0	1,016	2,147
13,550	**13,600**	0	2,350	3,906	**16,350**	**16,400**	0	1,903	3,316	**19,150**	**19,200**	0	1,455	2,726	**21,950**	**22,000**	0	1,008	2,137
13,600	**13,650**	0	2,342	3,895	**16,400**	**16,450**	0	1,895	3,306	**19,200**	**19,250**	0	1,447	2,716	**22,000**	**22,050**	0	1,000	2,126
13,650	**13,700**	0	2,334	3,885	**16,450**	**16,500**	0	1,887	3,295	**19,250**	**19,300**	0	1,439	2,705	**22,050**	**22,100**	0	992	2,116
13,700	**13,750**	0	2,326	3,874	**16,500**	**16,550**	0	1,879	3,285	**19,300**	**19,350**	0	1,431	2,695	**22,100**	**22,150**	0	984	2,105
13,750	**13,800**	0	2,318	3,864	**16,550**	**16,600**	0	1,871	3,274	**19,350**	**19,400**	0	1,423	2,684	**22,150**	**22,200**	0	976	2,095
13,800	**13,850**	0	2,310	3,853	**16,600**	**16,650**	0	1,863	3,264	**19,400**	**19,450**	0	1,415	2,674	**22,200**	**22,250**	0	968	2,084
13,850	**13,900**	0	2,302	3,843	**16,650**	**16,700**	0	1,855	3,253	**19,450**	**19,500**	0	1,407	2,663	**22,250**	**22,300**	0	960	2,074

*If the amount you are looking up from the worksheet is at least $10,700 but less than $10,710, your credit is $1. Otherwise, you cannot take the credit.

(Continued on page 50)

Need more information or forms? See page 7.

2001 Earned Income Credit (EIC) Table *Continued* (**Caution.** This is **not** a tax table.)

If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—			If the amount you are looking up from the worksheet is—		And you have—		
At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children	At least	But less than	No children	One child	Two children
		Your credit is—					Your credit is—					Your credit is—					Your credit is—		
22,300	**22,350**	0	952	2,063	**24,900**	**24,950**	0	536	1,516	**27,500**	**27,550**	0	121	968	**30,100**	**30,150**	0	0	420
22,350	**22,400**	0	944	2,053	**24,950**	**25,000**	0	528	1,505	**27,550**	**27,600**	0	113	957	**30,150**	**30,200**	0	0	410
22,400	**22,450**	0	936	2,042	**25,000**	**25,050**	0	520	1,494	**27,600**	**27,650**	0	105	947	**30,200**	**30,250**	0	0	399
22,450	**22,500**	0	928	2,032	**25,050**	**25,100**	0	512	1,484	**27,650**	**27,700**	0	97	936	**30,250**	**30,300**	0	0	389
22,500	**22,550**	0	920	2,021	**25,100**	**25,150**	0	504	1,473	**27,700**	**27,750**	0	89	926	**30,300**	**30,350**	0	0	378
22,550	**22,600**	0	912	2,010	**25,150**	**25,200**	0	496	1,463	**27,750**	**27,800**	0	81	915	**30,350**	**30,400**	0	0	368
22,600	**22,650**	0	904	2,000	**25,200**	**25,250**	0	488	1,452	**27,800**	**27,850**	0	73	905	**30,400**	**30,450**	0	0	357
22,650	**22,700**	0	896	1,989	**25,250**	**25,300**	0	480	1,442	**27,850**	**27,900**	0	65	894	**30,450**	**30,500**	0	0	347
22,700	**22,750**	0	888	1,979	**25,300**	**25,350**	0	472	1,431	**27,900**	**27,950**	0	57	884	**30,500**	**30,550**	0	0	336
22,750	**22,800**	0	880	1,968	**25,350**	**25,400**	0	464	1,421	**27,950**	**28,000**	0	49	873	**30,550**	**30,600**	0	0	326
22,800	**22,850**	0	872	1,958	**25,400**	**25,450**	0	456	1,410	**28,000**	**28,050**	0	41	863	**30,600**	**30,650**	0	0	315
22,850	**22,900**	0	864	1,947	**25,450**	**25,500**	0	448	1,400	**28,050**	**28,100**	0	33	852	**30,650**	**30,700**	0	0	305
22,900	**22,950**	0	856	1,937	**25,500**	**25,550**	0	440	1,389	**28,100**	**28,150**	0	25	842	**30,700**	**30,750**	0	0	294
22,950	**23,000**	0	848	1,926	**25,550**	**25,600**	0	432	1,379	**28,150**	**28,200**	0	17	831	**30,750**	**30,800**	0	0	284
23,000	**23,050**	0	840	1,916	**25,600**	**25,650**	0	425	1,368	**28,200**	**28,250**	0	9	821	**30,800**	**30,850**	0	0	273
23,050	**23,100**	0	832	1,905	**25,650**	**25,700**	0	417	1,358	**28,250**	**28,300**	0	**	810	**30,850**	**30,900**	0	0	262
23,100	**23,150**	0	824	1,895	**25,700**	**25,750**	0	409	1,347	**28,300**	**28,350**	0	0	800	**30,900**	**30,950**	0	0	252
23,150	**23,200**	0	816	1,884	**25,750**	**25,800**	0	401	1,337	**28,350**	**28,400**	0	0	789	**30,950**	**31,000**	0	0	241
23,200	**23,250**	0	808	1,874	**25,800**	**25,850**	0	393	1,326	**28,400**	**28,450**	0	0	778	**31,000**	**31,050**	0	0	231
23,250	**23,300**	0	800	1,863	**25,850**	**25,900**	0	385	1,315	**28,450**	**28,500**	0	0	768	**31,050**	**31,100**	0	0	220
23,300	**23,350**	0	792	1,853	**25,900**	**25,950**	0	377	1,305	**28,500**	**28,550**	0	0	757	**31,100**	**31,150**	0	0	210
23,350	**23,400**	0	784	1,842	**25,950**	**26,000**	0	369	1,294	**28,550**	**28,600**	0	0	747	**31,150**	**31,200**	0	0	199
23,400	**23,450**	0	776	1,831	**26,000**	**26,050**	0	361	1,284	**28,600**	**28,650**	0	0	736	**31,200**	**31,250**	0	0	189
23,450	**23,500**	0	768	1,821	**26,050**	**26,100**	0	353	1,273	**28,650**	**28,700**	0	0	726	**31,250**	**31,300**	0	0	178
23,500	**23,550**	0	760	1,810	**26,100**	**26,150**	0	345	1,263	**28,700**	**28,750**	0	0	715	**31,300**	**31,350**	0	0	168
23,550	**23,600**	0	752	1,800	**26,150**	**26,200**	0	337	1,252	**28,750**	**28,800**	0	0	705	**31,350**	**31,400**	0	0	157
23,600	**23,650**	0	744	1,789	**26,200**	**26,250**	0	329	1,242	**28,800**	**28,850**	0	0	694	**31,400**	**31,450**	0	0	147
23,650	**23,700**	0	736	1,779	**26,250**	**26,300**	0	321	1,231	**28,850**	**28,900**	0	0	684	**31,450**	**31,500**	0	0	136
23,700	**23,750**	0	728	1,768	**26,300**	**26,350**	0	313	1,221	**28,900**	**28,950**	0	0	673	**31,500**	**31,550**	0	0	126
23,750	**23,800**	0	720	1,758	**26,350**	**26,400**	0	305	1,210	**28,950**	**29,000**	0	0	663	**31,550**	**31,600**	0	0	115
23,800	**23,850**	0	712	1,747	**26,400**	**26,450**	0	297	1,200	**29,000**	**29,050**	0	0	652	**31,600**	**31,650**	0	0	105
23,850	**23,900**	0	704	1,737	**26,450**	**26,500**	0	289	1,189	**29,050**	**29,100**	0	0	642	**31,650**	**31,700**	0	0	94
23,900	**23,950**	0	696	1,726	**26,500**	**26,550**	0	281	1,179	**29,100**	**29,150**	0	0	631	**31,700**	**31,750**	0	0	83
23,950	**24,000**	0	688	1,716	**26,550**	**26,600**	0	273	1,168	**29,150**	**29,200**	0	0	620	**31,750**	**31,800**	0	0	73
24,000	**24,050**	0	680	1,705	**26,600**	**26,650**	0	265	1,158	**29,200**	**29,250**	0	0	610	**31,800**	**31,850**	0	0	62
24,050	**24,100**	0	672	1,695	**26,650**	**26,700**	0	257	1,147	**29,250**	**29,300**	0	0	599	**31,850**	**31,900**	0	0	52
24,100	**24,150**	0	664	1,684	**26,700**	**26,750**	0	249	1,136	**29,300**	**29,350**	0	0	589	**31,900**	**31,950**	0	0	41
24,150	**24,200**	0	656	1,673	**26,750**	**26,800**	0	241	1,126	**29,350**	**29,400**	0	0	578	**31,950**	**32,000**	0	0	31
24,200	**24,250**	0	648	1,663	**26,800**	**26,850**	0	233	1,115	**29,400**	**29,450**	0	0	568	**32,000**	**32,050**	0	0	20
24,250	**24,300**	0	640	1,652	**26,850**	**26,900**	0	225	1,105	**29,450**	**29,500**	0	0	557	**32,050**	**32,100**	0	0	10
24,300	**24,350**	0	632	1,642	**26,900**	**26,950**	0	217	1,094	**29,500**	**29,550**	0	0	547	**32,100**	**32,121**	0	0	2
24,350	**24,400**	0	624	1,631	**26,950**	**27,000**	0	209	1,084	**29,550**	**29,600**	0	0	536	**32,121 or more**		0	0	0
24,400	**24,450**	0	616	1,621	**27,000**	**27,050**	0	201	1,073	**29,600**	**29,650**	0	0	526					
24,450	**24,500**	0	608	1,610	**27,050**	**27,100**	0	193	1,063	**29,650**	**29,700**	0	0	515					
24,500	**24,550**	0	600	1,600	**27,100**	**27,150**	0	185	1,052	**29,700**	**29,750**	0	0	505					
24,550	**24,600**	0	592	1,589	**27,150**	**27,200**	0	177	1,042	**29,750**	**29,800**	0	0	494					
24,600	**24,650**	0	584	1,579	**27,200**	**27,250**	0	169	1,031	**29,800**	**29,850**	0	0	484					
24,650	**24,700**	0	576	1,568	**27,250**	**27,300**	0	161	1,021	**29,850**	**29,900**	0	0	473					
24,700	**24,750**	0	568	1,558	**27,300**	**27,350**	0	153	1,010	**29,900**	**29,950**	0	0	463					
24,750	**24,800**	0	560	1,547	**27,350**	**27,400**	0	145	1,000	**29,950**	**30,000**	0	0	452					
24,800	**24,850**	0	552	1,537	**27,400**	**27,450**	0	137	989	**30,000**	**30,050**	0	0	441					
24,850	**24,900**	0	544	1,526	**27,450**	**27,500**	0	129	979	**30,050**	**30,100**	0	0	431					

**If the amount you are looking up from the worksheet is at least $28,250 but less than $28,281, your credit is $3. Otherwise, you cannot take the credit.

Line 62

Excess Social Security and RRTA Tax Withheld

If you, or your spouse if filing a joint return, had more than one employer for 2001 and total wages of more than $80,400, too much social security tax may have been withheld. You can take a credit on this line for the amount withheld in excess of $4,984.80. But if any one employer withheld more than $4,984.80, you must ask that employer to refund the excess to you. You cannot claim it on your return. Figure this amount separately for you and your spouse.

If you had more than one railroad employer for 2001 and your total compensation was over $59,700, too much railroad retirement (RRTA) tax may have been withheld.

For more details, see **Pub. 505.**

Line 63

Additional Child Tax Credit

What Is the Additional Child Tax Credit?

This credit is for certain people who have at least one qualifying child as defined in the instructions for line 6c, column (4), on page 20. The additional child tax credit may give you a refund even if you do not owe any tax.

Two Steps To Take the Additional Child Tax Credit!

Step 1. Be sure you figured the amount, if any, of your child tax credit. See the instructions for line 48 that begin on page 37.

Step 2. Read the **TIP** at the end of your Child Tax Credit Worksheet. Use Form 8812 to see if you can take the additional child tax credit only if you meet the condition given in that TIP.

Line 64

Amount Paid With Request for Extension To File

If you filed **Form 4868** to get an automatic extension of time to file Form 1040, enter any amount you paid with that form or by electronic funds withdrawal or credit card. If you paid by credit card, do not include on line 64 the convenience fee you were charged. Also, include any amounts paid with **Form 2688** or **2350.**

Line 65

Other Payments

Check the box(es) on line 65 to report any credit from **Form 2439** or **4136.**

Refund

Line 67

Amount Overpaid

If line 67 is under $1, we will send a refund only on written request.

If you want to check the status of your refund, please wait at least 4 weeks from the date you filed your return to do so. See page 11 for details.

If the amount you overpaid is large, you may want to decrease the amount of income tax withheld from your pay by filing a new **Form W-4.** See **Income Tax Withholding and Estimated Tax Payments for 2002** on page 54.

Refund Offset

If you owe past-due Federal tax, state income tax, child support, spousal support, or certain Federal nontax debts, such as student loans, all or part of the overpayment on line 67 may be used (offset) to pay the past-due amount. Offsets for Federal taxes are made by the IRS. All other offsets are made by the Treasury Department's Financial Management Service (FMS). You will receive a notice from FMS showing the amount of the offset and the agency receiving it. To find out if you may have an offset or if you have any questions about it, contact the agency(ies) you owe the debt to.

Injured Spouse Claim

If you file a joint return and your spouse has not paid past-due Federal tax, state income tax, child support, spousal support, or a Federal nontax debt, such as a student loan, part or all of the overpayment on line 67 may be used (offset) to pay the past-due amount. But **your** part of the overpayment may be refunded to you after the offset occurs if certain conditions apply and you complete **Form 8379.** For details, use TeleTax topic 203 (see page 11) or see Form 8379.

Lines 68b Through 68d

Direct Deposit of Refund

Complete lines 68b through 68d if you want us to directly deposit the amount shown on line 68a into your account at a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) instead of sending you a check.

Why Use Direct Deposit?

- You get your refund fast—even faster if you *e-file!*
- Payment is more secure—there is no check to get lost.
- More convenient. No trip to the bank to deposit your check.
- Saves tax dollars. A refund by direct deposit costs less than a check.

You can check with your financial institution to make sure your deposit will be accepted and to get the correct routing and account numbers. The IRS is not responsible for a lost refund if you enter the wrong account information.

If you file a joint return and fill in lines 68b through 68d, you are appointing your spouse as an agent to receive the refund. This appointment cannot be changed later.

Line 68b

The routing number **must** be **nine** digits. The first two digits must be 01 through 12 or 21 through 32. Otherwise, the direct deposit will be rejected and a check sent instead. On the sample check on page 52, the routing number is 250250025.

Your check may state that it is payable through a financial institution different from the one at which you have your checking account. If so, **do not** use the routing number on that check. Instead, contact your financial institution for the correct routing number to enter on line 68b.

Line 68d

The account number can be up to 17 characters (both numbers and letters). Include hyphens but omit spaces and special symbols. Enter the number from left to right and leave any unused boxes blank. On the sample check on page 52, the account number is 20202086. Be sure **not** to include the check number.

(Continued on page 52)

Need more information or forms? See page 7.

CAUTION Some financial institutions will not allow a joint refund to be deposited into an individual account. If the direct deposit is rejected, a check will be sent instead. The IRS is not responsible if a financial institution rejects a direct deposit.

Line 69

Applied to Your 2002 Estimated Tax

Enter on line 69 the amount, if any, of the overpayment on line 67 you want applied to your 2002 estimated tax. We will apply this amount to your account unless you attach a statement requesting us to apply it to your spouse's account. Include your spouse's social security number in the attached statement.

CAUTION This election to apply part or all of the amount overpaid to your 2002 estimated tax cannot be changed later.

Amount You Owe

Line 70

Amount You Owe

TIP You do not have to pay if line 70 is under $1.

Include any estimated tax penalty from line 71 in the amount you enter on line 70.

You can pay by check, money order, or credit card. **Do not** include any estimated tax payment in your check, money order, or amount you charge. Instead, make the estimated tax payment separately.

To Pay by Check or Money Order. Make your check or money order payable to the **"United States Treasury"** for the full amount due. **Do not** send cash. **Do not** attach the payment to your return. Write "2001 Form 1040" and your name, address, daytime phone number, and social security number (SSN) on your payment. If you are filing a joint return, enter the SSN shown first on your tax return.

To help us process your payment, enter the amount on the right side of the check like this: $ XXX.XX. Do not use dashes or lines (for example, do not enter "$ XXX–" or "$ XXX $\frac{XX}{100}$").

Then, please complete **Form 1040-V** following the instructions on that form and enclose it in the envelope with your tax return and payment. Although you do not have to use Form 1040-V, doing so allows us to process your payment more accurately and efficiently.

To Pay by Credit Card. You may use your American Express® Card, Discover® Card, or MasterCard® card. To pay by credit card, call toll free or access by Internet one of the service providers listed on this page and follow the instructions. A convenience fee will be charged by the service provider based on the amount you are paying. Fees may vary between the providers. You will be told what the fee is during the transaction and you will have the option to either continue or cancel the transaction. You can also find out what the fee will be by calling the provider's toll-free automated customer service number or visiting the provider's Web Site shown below. **If you paid by credit card,** enter on page 1 of Form 1040 in the upper left corner the confirmation number you were given at the end of the transaction and the amount you charged (not including the convenience fee).

PhoneCharge, Inc.
1-888-ALLTAXX (1-888-255-8299)
1-877-851-9964 (Customer Service)
www.1888ALLTAXX.com

Official Payments Corporation
1-800-2PAY-TAX (1-800-272-9829)
1-877-754-4413 (Customer Service)
www.officialpayments.com

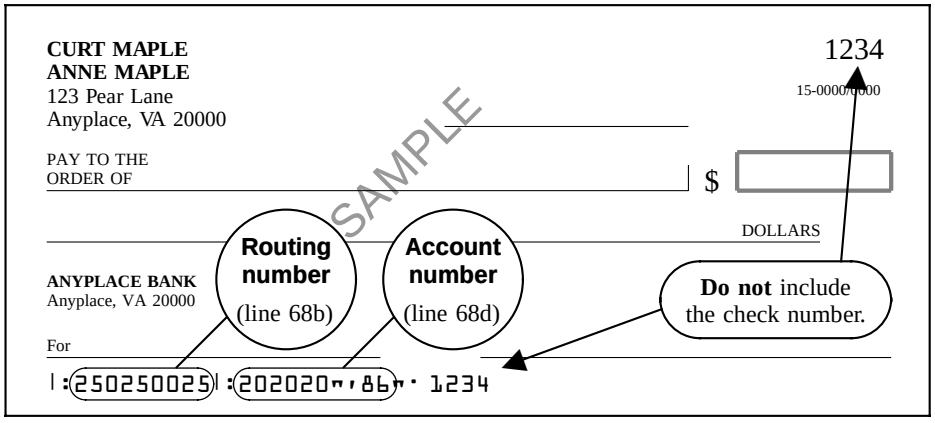
TIP You may need to **(a)** increase the amount of income tax withheld from your pay by filing a new **Form W-4** or **(b)** make estimated tax payments for 2002. See **Income Tax Withholding and Estimated Tax Payments for 2002** on page 54.

What if You Cannot Pay?

If you cannot pay the full amount shown on line 70 when you file, you may ask to make monthly **installment payments.** You may have up to 60 months to pay. However, you will be charged interest and may be charged a late payment penalty on the tax not paid by April 15, 2002, even if your request to pay in installments is granted. You must also pay a fee. To limit the interest and penalty charges, pay as much of the tax as possible when you file. But before requesting an installment agreement, you should consider other less costly alternatives, such as a bank loan.

To ask for an installment agreement, use **Form 9465.** You should receive a response to your request for installments within 30 days. But if you file your return after March 31, it may take us longer to reply.

Sample Check—Lines 68b Through 68d



Note. The routing and account numbers may be in different places on your check.

Line 71

Estimated Tax Penalty

CAUTION You must include household employment taxes reported on line 57 to see if you owe the penalty if line 59 is more than zero **or** you would owe the penalty even if you did not include those taxes. But if you entered an amount on Schedule H, line 7, include the total of that amount plus the amount on Form 1040, line 57.

(Continued on page 53)

You may owe this penalty if:

- Line 70 is at least $1,000 and it is more than 10% of the tax shown on your return or
- You did not pay enough estimated tax by any of the due dates. This is true even if you are due a refund.

For most people, the "tax shown on your return" is the amount on line 58 minus the total of any amounts shown on lines 61a and 63 and Forms 8828, 4137, 4136, and 5329 (Parts III, IV, V, VI, and VII only).

Exception. You will not owe the penalty if your 2000 tax return was for a tax year of 12 full months **and either** of the following applies.

1. You had no tax liability for 2000 and you were a U.S. citizen or resident for all of 2000 **or**

2. The total of lines 59, 60, and 62 on your 2001 return is at least as much as the tax liability shown on your 2000 return. Your estimated tax payments for 2001 must have been made on time and for the required amount.

If your 2000 adjusted gross income was over $150,000 (over $75,000 if your 2001 filing status is married filing separately), item **2** above applies only if the total of lines 59, 60, and 62 on your 2001 return is at least 110% of the tax liability shown on your 2000 return. This rule does not apply to farmers and fishermen.

Figuring the Penalty

If the **Exception** above does not apply and you choose to figure the penalty yourself, see **Form 2210** (or **2210-F** for farmers and fishermen) to find out if you owe the penalty. If you do, you can use the form to figure the amount. In certain situations, you may be able to lower your penalty. For details, see the Instructions for Form 2210 (or 2210-F).

Enter the penalty on line 71. Add the penalty to any tax due and enter the total on line 70. If you are due a refund, subtract the penalty from the overpayment you show on line 67. **Do not** file Form 2210 with your return unless Form 2210 indicates that you must do so. Instead, keep it for your records.

Because Form 2210 is complicated, if you want to, you can leave line 71 blank and the IRS will figure the penalty and send you a bill. We will not charge you interest on the penalty if you pay by the date specified on the bill.

Third Party Designee

If you want to allow a friend, family member, or any other person you choose to discuss your 2001 tax return with the IRS, check the "Yes" box in the "Third Party Designee" area of your return. Also, enter the designee's name, phone number, and any five numbers the designee chooses as his or her personal identification number (PIN). **But** if you want to allow the paid preparer who signed your return to discuss it with the IRS, just enter "Preparer" in the space for the designee's name. You do not have to provide the other information requested.

If you check the "Yes" box, you, and your spouse if filing a joint return, are authorizing the IRS to call the designee to answer any questions that may arise during the processing of your return. You are also authorizing the designee to:

- Give the IRS any information that is missing from your return,
- Call the IRS for information about the processing of your return or the status of your refund or payment(s), and
- Respond to certain IRS notices that you have shared with the designee about math errors, offsets, and return preparation. The notices will not be sent to the designee.

You are not authorizing the designee to receive any refund check, bind you to anything (including any additional tax liability), or otherwise represent you before the IRS. If you want to expand the designee's authorization, see **Pub. 947.**

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (without regard to extensions) for filing your 2002 tax return. This is April 15, 2003, for most people.

Sign Your Return

Form 1040 is not considered a valid return unless you sign it. If you are filing a joint return, your spouse must also sign. If your spouse cannot sign the return, see **Pub. 501.** If you have someone prepare your return, you are still responsible for the correctness of the return. If you are filing a joint return as a surviving spouse, see **Death of a Taxpayer** on page 55.

Child's Return

If your child cannot sign the return, either parent may sign the child's name in the space provided. Then, add "By (your signature), parent for minor child."

Daytime Phone Number

Providing your daytime phone number may help speed the processing of your return. We may have questions about items on your return, such as the earned income credit, credit for child and dependent care expenses, etc. By answering our questions over the phone, we may be able to continue processing your return without mailing you a letter. If you are filing a joint return, you may enter either your or your spouse's daytime phone number.

Paid Preparer Must Sign Your Return

Generally, anyone you pay to prepare your return must sign it by hand in the space provided. Signature stamps or labels cannot be used. The preparer must give you a copy of the return for your records. Someone who prepares your return but does not charge you should not sign your return.

Assemble Your Return

Assemble any schedules and forms behind Form 1040 in order of the "Attachment Sequence No." shown in the upper right corner of the schedule or form. If you have supporting statements, arrange them in the same order as the schedules or forms they support and attach them last. **Do not** attach correspondence or other items unless required to do so. Attach a copy of Forms W-2, W-2G, and 2439 to the front of Form 1040. Also attach Form(s) 1099-R to the front of Form 1040 if tax was withheld.

Need more information or forms? See page 7.

General Information

How To Avoid Common Mistakes

Mistakes may delay your refund or result in notices being sent to you.

1. Make sure you entered the correct name and social security number (SSN) for each dependent you claim on line 6c. Also, make sure you check the box in column (4) of line 6c for each dependent under age 17 who is also a qualifying child for the child tax credit.

2. Check your math, especially for the child tax credit, earned income credit, taxable social security benefits, total income, itemized deductions or standard deduction, deduction for exemptions, taxable income, total tax, Federal income tax withheld, and refund or amount you owe.

3. Be sure you use the correct method to figure your tax. See the instructions for line 40 that begin on page 33.

4. Be sure to enter your SSN in the space provided on page 1 of Form 1040. If you are married filing a joint or separate return, also enter your spouse's SSN. Be sure to enter your SSN in the space next to your name.

5. Make sure your name and address are correct on the peel-off label. If not, enter the correct information. If you did not get a peel-off label, enter your (and your spouse's) name in the same order as shown on your last return.

6. If you are taking the standard deduction and you checked any box on line 35a or you (or your spouse if filing jointly) can be claimed as a dependent on someone else's 2001 return, see page 31 to be sure you entered the correct amount on line 36.

7. If you received capital gain distributions but were not required to file Schedule D, make sure you check the box on line 13.

8. Remember to **sign** and date Form 1040 and enter your occupation.

9. Attach your W-2 form(s) and other required forms and schedules. Put all forms and schedules in the proper order. See **Assemble Your Return** on page 53.

10. If you owe tax and are paying by check or money order, be sure to include all the required information on your payment. See the instructions for line 70 on page 52 for details.

What Are Your Rights as a Taxpayer?

You have the right to be treated fairly, professionally, promptly, and courteously by IRS employees. Our goal at the IRS is to protect your rights so that you will have the highest confidence in the integrity, efficiency, and fairness of our tax system. To ensure that you always receive such treatment, you should know about the many rights you have at each step of the tax process. For details, see **Pub. 1.**

Innocent Spouse Relief

You may qualify for relief from liability for tax on a joint return if **(a)** there is an understatement of tax because your spouse omitted income or claimed false deductions or credits, **(b)** you are divorced, separated, or no longer living with your spouse, **or (c)** given all the facts and circumstances, it would not be fair to hold you liable. See **Form 8857** or **Pub. 971** for more details.

Income Tax Withholding and Estimated Tax Payments for 2002

If the amount you owe or the amount you overpaid is large, you may want to file a new **Form W-4** with your employer to change the amount of income tax withheld from your 2002 pay. For details on how to complete Form W-4, see **Pub. 919** or visit the IRS Web Site at www.irs.gov/prod/ind_info/webw4/index.html.

In general, you do not have to make estimated tax payments if you expect that your 2002 Form 1040 will show a tax refund **or** a tax balance due the IRS of less than $1,000. If your total estimated tax (including any household employment taxes or alternative minimum tax) for 2002 is $1,000 or more, see **Form 1040-ES.** It has a worksheet you can use to see if you have to make estimated tax payments. For more details, see **Pub. 505.**

Do Both the Name and SSN on Your Tax Forms Agree With Your Social Security Card?

If not, certain deductions and credits may be reduced or disallowed, your refund may be delayed, and you may not receive credit for your social security earnings. If your Form W-2, Form 1099, or other tax document shows an incorrect SSN or name, notify your employer or the form-issuing agent as soon as possible to make sure your earnings are credited to your social security record. If the name or SSN on your social security card is incorrect, call the Social Security Administration at 1-800-772-1213.

How Do You Make a Gift To Reduce the Public Debt?

If you wish to do so, make a check payable to "Bureau of the Public Debt." You can send it to: Bureau of the Public Debt, Department G, P.O. Box 2188, Parkersburg, WV 26106-2188. Or you can enclose the check with your income tax return when you file. Do not add your gift to any tax you may owe. See page 52 for details on how to pay any tax you owe.

If you itemize your deductions for 2002, you may be able to deduct this gift.

Address Change

If you move after you file, always notify the IRS in writing of your new address. To do this, you can use **Form 8822.**

How Long Should Records Be Kept?

Keep a copy of your tax return, worksheets you used, and records of all items appearing on it (such as W-2 and 1099 forms) until the statute of limitations runs out for that return. Usually, this is 3 years from the date the return was due or filed, or 2 years from the date the tax was paid, whichever is later. You should keep some records longer. For example, keep property records (including those on your home) as long as they are needed to figure the basis of the original or replacement property. For more details, see **Pub. 552.**

Amended Return

File **Form 1040X** to change a return you already filed. Generally, Form 1040X must be filed within 3 years after the date the original return was filed, or within 2 years after the date the tax was paid, whichever is later. But you may have more time to file Form 1040X if you are physically or mentally unable to manage your financial affairs. See **Pub. 556** for details.

Need a Copy of Your Tax Return?

If you need a copy of your tax return, use **Form 4506.** If you have questions about your account, call or write your local IRS office. If you want a printed copy of your account, it will be mailed to you free of charge.

Death of a Taxpayer

If a taxpayer died before filing a return for 2001, the taxpayer's spouse or personal representative may have to file and sign a return for that taxpayer. A personal representative can be an executor, administrator, or anyone who is in charge of the deceased taxpayer's property. If the deceased taxpayer did not have to file a return but had tax withheld, a return must be filed to get a refund. The person who files the return should enter **"DECEASED,"** the deceased taxpayer's name, and the date of death across the top of the return.

If your spouse died in 2001 and you did not remarry in 2001, you can file a joint return. You can also file a joint return if your spouse died in 2002 before filing a return for 2001. A joint return should show your spouse's 2001 income before death and your income for all of 2001. Enter "Filing as surviving spouse" in the area where you sign the return. If someone else is the personal representative, he or she must also sign.

The surviving spouse or personal representative should promptly notify all payers of income, including financial institutions, of the taxpayer's death. This will ensure the proper reporting of income earned by the taxpayer's estate or heirs. A deceased taxpayer's social security number should not be used for tax years after the year of death, except for estate tax return purposes.

Claiming a Refund for a Deceased Taxpayer

If you are filing a joint return as a surviving spouse, you only need to file the tax return to claim the refund. If you are a court-appointed representative, file the return and attach a copy of the certificate that shows your appointment. All other filers requesting the deceased taxpayer's refund must file the return and attach **Form 1310.**

For more details, use TeleTax topic 356 (see page 11) or see **Pub. 559.**

IRS e-file

Delete the Paperwork. Hit SEND

So easy, no wonder 40 million people use it! You can file electronically, sign electronically, and get your refund or even pay electronically. IRS *e-file* offers accurate, safe, and fast alternatives to filing on paper. IRS computers quickly and automatically check for errors or other missing information. This year, almost all forms and schedules can be *e-filed.* Even returns with a foreign address can be *e-filed!* The chance of an audit of an *e-filed* tax return is no greater than with a paper filed return. Forty million taxpayers just like you filed their tax returns electronically using an IRS *e-file* option because of the many benefits:

- Accuracy!
- Security!
- Electronic Signatures!
- Proof of Acceptance!
- Fast Refunds!
- FREE/Low-Cost Filing!
- Electronic Payment Options!
- Federal/State *e-file*!

AUTHORIZED IRS e-file PROVIDER

Use an Authorized IRS *e-file* Provider. Many tax professionals can electronically file paperless returns for their clients. As a taxpayer, you have two options: **1.** You can prepare your return, take it to a tax professional, ask to sign it electronically using a five-digit self-selected Personal Identification Number (PIN) and then have the tax professional transmit it electronically to the IRS, or **2.** You can have a tax professional prepare your return, you can sign it electronically using a five-digit self-selected PIN, and have your preparer transmit it for you electronically.

Depending on the tax professional and the specific services requested, a fee may be charged. Look for the "Authorized IRS *e-file* Provider" sign or check the IRS Web Site at www.irs.gov for an "Authorized IRS *e-file* Provider" near you.

Use Your Personal Computer. A computer with a modem and/or Internet access is all you need to file your tax return using IRS *e-file.* You can buy tax preparation software at various electronics stores or computer and office supply stores. You can download software from the Internet or prepare and file your return completely on-line by using a tax preparation software package on the Internet (nothing to buy or install). Best of all, you can *e-file* your tax return from the comfort of your home any time of the day or night. Sign your return electronically using a five-digit self-selected PIN to complete the process. There is no signature form to submit or Forms W-2 to send in. IRS *e-file* is totally paperless! Within 48 hours of filing, you will receive confirmation that the IRS has received your return. To find free and low-cost *e-file* opportunities for taxpayers who qualify or a list of all software companies that participate in the IRS *e-file* program, visit our Web Site at www.irs.gov. Once your return is prepared, you will need a modem and/or Internet access to file it electronically.

Your TeleFile Your Easiest Way To File

Use a Telephone. For millions of eligible taxpayers, TeleFile is the easiest way to file. TeleFile allows you to file your simple Federal income tax return using a touch-tone telephone. Only taxpayers who met the qualifications for Form 1040EZ in the prior year are eligible to receive the TeleFile Tax Package for the current year. A TeleFile Tax Package is automatically mailed to you if you are eligible. **Parents: If your children receive a TeleFile Tax Package, please encourage them to use TeleFile.**

Through Employers and Financial Institutions. Some businesses offer free *e-file* to their employees, members, or customers. Others offer it for a fee. Ask your employer or financial institution if they offer IRS *e-file* as an employee, member, or customer benefit.

Visit a VITA or TCE Site. Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites are open to low-income individuals, others who need help with their tax returns, and the elderly. Both programs are free and can be found at many libraries, colleges, universities, shopping malls, and retirement and senior centers. Find the closest VITA or TCE site by calling 1-800-829-1040. Remember to take your spouse's, your dependent's, and your own social security cards and other identifying documents. Ask for IRS *e-file* at these sites.

DIRECT DEPOSIT
Simple. Safe. Secure.

Fast Refunds!

Choose Direct Deposit—a fast, simple, safe, secure way to have your Federal income tax refund deposited automatically into your checking or savings account. To choose Direct Deposit, taxpayers are prompted by the tax preparation software to indicate on the refund portion of the electronic return the financial institution's routing number, account number, and type of account—either checking or savings. Taxpayers who file electronically receive their refunds in less than half the time paper filers do and with Direct Deposit—in as few as 10 days!

Electronic Signatures! Paperless filing is easier than you think and it's available to most taxpayers who file electronically—including those first-time filers who were 16 or older on December 31, 2001. It's available to individuals preparing their own returns using tax preparation software or those who use a tax professional. Regardless of the *e-filing* method you choose, you may be able to participate in the Self-Select PIN program. If you are married filing a joint return, you and your spouse will each need to create a PIN and enter it as your electronic signature.

If using tax preparation software, the process includes completing your income tax return on your personal computer and when prompted, signing electronically. You will enter a five-digit PIN that will serve as your electronic signature.

For more details on qualifications and required taxpayer information for the Self-Select PIN or on IRS *e-file*, please visit the IRS Web Site at www.irs.gov.

Forms 8453 and 8453-OL. Your return is not complete without your signature. If you are not eligible or choose not to participate in the Self-Select PIN program for signing your return electronically, you must complete and sign **Form 8453** or **Form 8453-OL,** whichever applies.

Electronic Payment Options! If you owe tax, you can make your payment electronically.

Electronic Funds Withdrawal. You can *e-file* and pay in a single step by authorizing an electronic funds withdrawal from your checking or savings account. This option is available using tax software packages, tax professionals, and TeleFile.

Credit Card. You can also *e-file* and pay in a single step by authorizing a credit card payment. This option is available through some tax preparation software packages and tax professionals. Two other ways to pay by credit card are by telephone or Internet (see **Amount You Owe** on page 52 for details). Service providers charge a convenience fee for credit card payments.

Federal/State *e-file*! File Federal and state tax returns together using *e-file* and double the benefits of *e-file*! The tax preparation software automatically transfers relevant data from the Federal income tax return to the state income tax return as the information is entered. Currently, 37 states and the District of Columbia participate in the Federal/State *e-file* program. To see a complete list of states, check the IRS Web Site at www.irs.gov.

Delete the Paperwork. Hit SEND

All tax returns prepared electronically should be filed electronically. It's just a matter of clicking Send instead of Print! **Remember!** You get automatic confirmation within 48 hours that the IRS received your *e-filed* income tax return for processing.

IRS e-file for Business **Is Also Available!** IRS *e-file* for Business is an electronic method to file business returns. For details, visit the IRS Web Site at www.irs.gov.

EFTPS™ Electronic Federal Tax Payment System ***Electronic Federal Tax Payment System*** offers another way to pay your Federal taxes. It's available to business and individual taxpayers. For details, visit www.EFTPS.gov or call EFTPS Customer Service at **1-800-555-4477** or **1-800-945-8400.**

Other Ways To Get Help

Send Your Written Tax Questions to the IRS. You should get an answer in about 30 days. If you do not have the address, call us. See page 13 for the number. Do not send questions with your return.

Assistance With Your Return. IRS offices can help you prepare your return. An assister will explain a Form 1040EZ, 1040A, or 1040 with Schedules A and B to you and other taxpayers in a group setting. You may also be able to file your return electronically by computer free of charge at some IRS offices. To find the IRS office nearest you, look in the phone book under "United States Government, Internal Revenue Service" or call us. See page 13 for the number.

VITA and TCE. These programs help older, disabled, low-income, and non-English-speaking people fill in their returns. For details, call us. See page 13 for the number. If you received a Federal income tax package in the mail, take it with you when you go for help. Also take a copy of your 2000 tax return if you have it. **Or** to find the nearest AARP Tax-Aide site, visit AARP's Web Site at www.aarp.org/taxaide or call **1-877-227-7844.**

On-Line Services. If you subscribe to an on-line service, ask about on-line filing or tax information.

Large-Print Forms and Instructions. Pub. 1614 has large-print copies of Form 1040, Schedules A, B, D, E, EIC, and R, and Forms 1040-V and 8812, and their instructions. You can use the large-print forms and schedules as worksheets to figure your tax, but you cannot file them. You can get Pub. 1614 by phone or mail. See pages 7 and 57.

Help for People With Disabilities. Telephone help is available using TTY/TDD equipment. See page 13 for the number. Braille materials are available at libraries that have special services for people with disabilities.

Interest and Penalties

Note. You do not have to figure the amount of any interest or penalties you may owe. Because figuring these amounts can be complicated, we will do it for you if you want. We will send you a bill for any amount due.

If you include interest or penalties (other than the estimated tax penalty) with your payment, identify and enter the amount in the bottom margin of Form 1040, page 2. **Do not** include interest or penalties (other than the estimated tax penalty) in the **amount you owe** on line 70.

Interest

We will charge you interest on taxes not paid by their due date, even if an extension of time to file is granted. We will also charge you interest on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, and substantial understatements of tax. Interest is charged on the penalty from the due date of the return (including extensions).

Penalties

Late Filing. If you do not file your return by the due date (including extensions), the penalty is usually 5% of the amount due for each month or part of a month your return is late, unless you have a reasonable explanation. If you do, attach it to your return. The penalty can be as much as 25% (more in some cases) of the tax due. If your return is more than 60 days late, the minimum penalty will be $100 or the amount of any tax you owe, whichever is smaller.

Late Payment of Tax. If you pay your taxes late, the penalty is usually ½ of 1% of the unpaid amount for each month or part of a month the tax is not paid. The penalty can be as much as 25% of the unpaid amount. It applies to any unpaid tax on the return. This penalty is in addition to interest charges on late payments.

Frivolous Return. In addition to any other penalties, the law imposes a penalty of $500 for filing a frivolous return. A frivolous return is one that does not contain information needed to figure the correct tax or shows a substantially incorrect tax because you take a frivolous position or desire to delay or interfere with the tax laws. This includes altering or striking out the preprinted language above the space where you sign.

Other. Other penalties can be imposed for negligence, substantial understatement of tax, and fraud. Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement. See **Pub. 17** for details on some of these penalties.

Order Blank for Forms and Publications

The most frequently ordered forms and publications are listed on the order blank below. See pages 8 through 10 for the titles of the forms and publications. We will mail you two copies of each form and one copy of each publication you order. To help reduce waste, please order only the items you need to prepare your return.

TIP For faster ways of getting the items you need, such as by computer or fax, see page 7.

How To Use the Order Blank

Circle the items you need on the order blank below. Use the blank spaces to order items not listed. If you need more space, attach a separate sheet of paper.

Print or type your name and address accurately in the space provided below. An accurate address will ensure delivery of your order. Cut the order blank on the dotted line. Enclose the order blank in your own envelope and send it to the IRS address shown below that applies to you. You should receive your order within 10 days after we receive your request.

Do not send your tax return to any of the addresses listed on this page. Instead, see the back cover.

Where To Mail Your Order Blank for Free Forms and Publications

IF you live in the . . .	THEN mail to . . .	AT this address . . .
Western United States	Western Area Distribution Center	Rancho Cordova, CA 95743-0001
Central United States	Central Area Distribution Center	P.O. Box 8903 Bloomington, IL 61702-8903
Eastern United States or a foreign country	Eastern Area Distribution Center	P.O. Box 85074 Richmond, VA 23261-5074

▲ *Cut here* ▲

Order Blank

Fill in your name and address.

Name

Postal mailing address Apt./Suite/Room

City State ZIP code

Foreign country International postal code

Daytime phone number
( )

The items in bold may be picked up at many IRS offices, post offices, and libraries. You may also download all these items from the Internet at www.irs.gov or place an electronic order for them.

Circle the forms and publications you need. The instructions for any form you order will be included.

1040	Schedule F (1040)	Schedule 3 (1040A)	2441	8812	Pub. 463	Pub. 527	Pub. 910
Schedules A&B (1040)	Schedule H (1040)	**1040EZ**	3903	8822	Pub. 501	Pub. 529	Pub. 926
Schedule C (1040)	Schedule J (1040)	1040-ES (2002)	4562	8829	Pub. 502	Pub. 535	Pub. 929
Schedule C-EZ (1040)	Schedule R (1040)	1040-V	4868	8863	Pub. 505	Pub. 550	Pub. 936
Schedule D (1040)	Schedule SE (1040)	1040X	5329	9465	Pub. 508	Pub. 554	Pub. 970
Schedule D-1 (1040)	**1040A**	2106	8283	Pub. 1	Pub. 521	Pub. 575	Pub. 972
Schedule E (1040)	**Schedule 1 (1040A)**	2106-EZ	8582	Pub. 17	Pub. 523	Pub. 590	
Schedule EIC (1040A or 1040)	**Schedule 2 (1040A)**	2210	8606	Pub. 334	Pub. 525	Pub. 596	

N

The IRS Restructuring and Reform Act of 1998, the Privacy Act of 1974, and Paperwork Reduction Act of 1980 require that when we ask you for information we must first tell you our legal right to ask for the information, why we are asking for it, and how it will be used. We must also tell you what could happen if we do not receive it and whether your response is voluntary, required to obtain a benefit, or mandatory under the law.

This notice applies to all papers you file with us, including this tax return. It also applies to any questions we need to ask you so we can complete, correct, or process your return; figure your tax; and collect tax, interest, or penalties.

Our legal right to ask for information is Internal Revenue Code sections 6001, 6011, and 6012(a) and their regulations. They say that you must file a return or statement with us for any tax you are liable for. Your response is mandatory under these sections. Code section 6109 requires that you provide your social security number or individual taxpayer identification number on what you file. This is so we know who you are, and can process your return and other papers. You must fill in all parts of the tax form that apply to you. But you do not have to check the boxes for the Presidential Election Campaign Fund or for the third-party designee. You also do not have to provide your daytime phone number.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law.

We ask for tax return information to carry out the tax laws of the United States. We need it to figure and collect the right amount of tax.

If you do not file a return, do not provide the information we ask for, or provide fraudulent information, you may be charged penalties and be subject to criminal prosecution. We may also have to disallow the exemptions, exclusions, credits, deductions, or adjustments shown on the tax return. This could make the tax higher or delay any refund. Interest may also be charged.

Generally, tax returns and return information are confidential, as stated in Code section 6103. However, Code section 6103 allows or requires the Internal Revenue Service to disclose or give the information shown on your tax return to others as described in the Code. For example, we may disclose your tax information to the Department of Justice, to enforce the tax laws, both civil and criminal, and to cities, states, the District of Columbia, U.S. commonwealths or possessions, and certain foreign governments to carry out their tax laws. We may disclose your tax information to the Department of Treasury and contractors for tax administration purposes; and to other persons as necessary to obtain information which we cannot get in any other way in order to determine the amount of or to collect the tax you owe. We may disclose your tax information to the Comptroller General of the United States to permit the Comptroller General to review the Internal Revenue Service. We may also disclose your tax information to Committees of Congress; Federal, state, and local child support agencies; and to other Federal agencies for the purposes of determining entitlement for benefits or the eligibility for and the repayment of loans.

Please keep this notice with your records. It may help you if we ask you for other information. If you have questions about the rules for filing and giving information, please call or visit any Internal Revenue Service office.

The Time It Takes To Prepare Your Return

We try to create forms and instructions that can be easily understood. Often this is difficult to do because our tax laws are very complex. For some people with income mostly from wages, filling in the forms is easy. For others who have businesses, pensions, stocks, rental income, or other investments, it is more difficult.

We Welcome Comments on Forms

If you have comments concerning the accuracy of the time estimates shown below or suggestions for making these forms simpler, we would be happy to hear from you. You can e-mail us your suggestions and comments through the IRS Internet Home Page (www.irs.gov/help/email2.html) or write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send your return to this address. Instead, see the back cover.

Estimated Preparation Time

The time needed to complete and file Form 1040, its schedules, and accompanying worksheets will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Totals
Form 1040	2 hr., 46 min.	3 hr., 30 min.	6 hr., 37 min.	34 min.	13 hr., 27 min.
Sch. A	3 hr., 4 min.	39 min.	1 hr., 34 min.	20 min.	5 hr., 37 min.
Sch. B	33 min.	8 min.	25 min.	20 min.	1 hr., 26 min.
Sch. C	6 hr., 4 min.	1 hr., 31 min.	2 hr., 19 min.	41 min.	10 hr., 35 min.
Sch. C-EZ	45 min.	3 min.	35 min.	20 min.	1 hr., 43 min.
Sch. D	1 hr., 29 min.	2 hr., 59 min.	2 hr., 34 min.	34 min.	7 hr., 36 min.
Sch. D-1	13 min.	1 min.	11 min.	34 min.	59 min.
Sch. E	3 hr.	1 hr.	1 hr., 24 min.	34 min.	5 hr., 58 min.
Sch. EIC	- - - - -	1 min.	13 min.	20 min.	34 min.
Sch. F:					
Cash Method	3 hr., 29 min.	36 min.	1 hr., 27 min.	20 min.	5 hr., 52 min.
Accrual Method	3 hr., 36 min.	26 min.	1 hr., 25 min.	20 min.	5 hr., 47 min.
Sch. H	1 hr., 38 min.	30 min.	53 min.	34 min.	3 hr., 35 min.
Sch. J	19 min.	11 min.	1 hr., 32 min.	20 min.	2 hr., 22 min.
Sch. R	19 min.	15 min.	30 min.	34 min.	1 hr., 38 min.
Sch. SE:					
Short	13 min.	14 min.	13 min.	13 min.	53 min.
Long	26 min.	20 min.	35 min.	20 min.	1 hr., 41 min.

Index to Instructions

A

Address Change . . . . . 19 and 54
Addresses of IRS Centers . . . . . Back Cover
Adjusted Gross Income 27–31
Adoption Expenses—
  Credit for 39
  Employer-Provided Benefits for 21
Advance Earned Income Credit Payments 39
Alimony Paid 30
Alimony Received 23
Alternative Minimum Tax . . . . 14, 34, and 35
Amended Return 54
Amount You Owe 52
Annuities 23–25
Archer MSAs 29
At-Risk Rules . . . . . C-6*, E-3*, and F-6*
Attachments to the Return 53

B

Blindness—Proof of 31
Business Income and Expenses (Schedule C) . . C-1*
Business Use of Home . . . A-5*, C-5*, and F-6*

C

Capital Gains and Losses (Schedule D) D-1*
Capital Gain Distributions . . . . 21, 23, and D-1*
Capital Gain Tax Worksheet 34
Casualty and Theft Losses A-5*
Charity—Gifts to A-4*
Child and Dependent Care Expenses—
  Credit for 35
Child Tax Credits . . . . . 14, 20, 37–38, and 51
Children of Divorced or Separated Parents . . . 20
Commissioner's Message 2
Community Property States 21
Contributions To Reduce the Public Debt . . . 54
Corrective Distributions 21
Customer Service Standards 6

D

Day-Care Center Expenses 35
Death of a Taxpayer 55
Debt, Gift To Reduce the Public 54
Dependent Care Benefits 21
Dependents—
  Exemptions for 20
  Standard Deduction 31
  Tax Computation Worksheet for . . . 14 and 33
  Who Can Be Claimed as 20
Direct Deposit of Refund 51–52
Disclosure, Privacy Act, and Paperwork Reduction
  Act Notice 72
Dividends—
  Nominee B-2*
  Other Distributions 21–22
Divorced or Separated Parents—Children of . . 20
Donations A-4*
Dual-Status Aliens 15

E

Earned Income Credit (EIC) . . . 14 and 41–50
  Nontaxable Earned Income 43
Education—
  Credits . . . . . 36 and A-5*
  Expenses . . . . . 28–29, 36, and A-5*
  Recapture of Education Credits 33
  Savings Accounts . . . . . 14, 23, 27, and 41
Elderly Persons—
  Expenses for Care of 35–36
  Credit for 35–36
  Standard Deduction 32
Electronic Filing *(e-file)* . . . . . 3 and 55–56
Employee Business Expenses A-5*
Estates and Trusts E-6*
Estimated Tax . . . . . 40, 52, 53, and 54
Excess Salary Deferrals 21
Excess Social Security and RRTA Tax Withheld . 51
Exemptions 19–20
Extension of Time To File . . . . . 15 and 51

F

Farm Income and Expenses (Schedule F) . . . F-1*
Farm Income Averaging (Schedule J) J-1*
Filing Requirements 15–16
Filing Status 19
Foreign Accounts and Trusts B-2*
Foreign-Source Income 20
Foreign Tax Credit 34–35
Form W-2 21
Forms W-2, 1098, and 1099—Where To
  Report Certain Items From 17–18
Forms—How To Get 7

G

Gambling . . . . . 27 and A-6*
Gifts to Charity A-4*
Golden Parachute Payments 40
Group-Term Life Insurance—Uncollected Tax on . 40

H

Head of Household 19
Health Insurance Deduction—Self-Employed . . 30
Help With Unresolved Tax Issues 6
Home—Sale of D-2*
Household Employment Taxes 39

I

Income 20–27
Income Tax Withholding (Federal) . . . 40 and 54
Individual Retirement Arrangements (IRAs)—
  Contributions to (line 23) . . . 14 and 27–28
  Distributions from (lines 15a and 15b) . . . 23
  Nondeductible Contributions to . . . 23 and 27
Injured Spouse Claim 51
Innocent Spouse Relief 54
Installment Payments . . . . . 13 and 52
Interest—
  Late Payment of Tax 56
  Penalty on Early Withdrawal of Savings . . . 30
Interest Income—
  Exclusion of Savings Bond Interest B-1*
  Nominee B-1*
  Taxable . . . . . 21 and B-1*
  Tax-Exempt . . . . . 21 and B-1*
Interest You Paid A-3*
Itemized Deductions or Standard Deduction . 31–32

K

Kidnapped Child—Parent of 14

L

Line Instructions for Form 1040 19–53
Long-Term Care Insurance . . . . 30 and A-1*
Lump-Sum Distributions 25

M

Medical and Dental Expenses A-1*
MSAs—Archer 29
Mileage Rates, Standard . 14, A-1*, A-4*, and C-3*
Miscellaneous Itemized Deductions . A-5* and A-6*
Mortgage Interest Credit . . . . . 39 and A-3*
Moving Expenses 29

N

Name Change . . . . . 19 and 54
National Debt—Gift To Reduce the 54
Nonresident Alien . . . . . 15 and 19

O

Order Blank for Forms and Publications . . . 57
Original Issue Discount (OID) B-1*
Other Income 27
Other Taxes 39–40

P

Partnerships E-5*
Partnership Expenses— Unreimbursed E-5*
Passive Activity—
  Losses . . . . . C-2*, E-4*, and F-2*
  Material Participation . . . . C-2* and F-2*
Payments 40–51
Penalty—
  Early Withdrawal of Savings 30
  Estimated Tax 52–53
  Frivolous Return 56
  Late Filing 56
  Late Payment 56
  Other 56
Pensions and Annuities 23–25
Presidential Election $3 Check-Off 19
Private Delivery Services 18
Public Debt—Gift To Reduce the 54
Publications—How To Get 7

Q

Qualified Retirement Plans—Deduction for . . . 30
Qualified State Tuition Program Earnings . 17 and 27

R

Railroad Retirement Benefits—
  Treated as a Pension 24
  Treated as Social Security 25
Rate Reduction Credit Worksheet . . . 14 and 36
Records—How Long To Keep 54
Refund 51–52
Refund Information 11
Refund Offset 51
Refunds, Credits, or Offsets of State and
  Local Income Taxes 22–23
Rental Income and Expenses (Schedule E) . . . E-1*
Retirement Plan Deduction—Self-Employed . . 30
Rights of Taxpayers 54
Rollovers . . . . . 23 and 25
Roth IRAs 23
Rounding Off to Whole Dollars 21
Royalties E-1*

S

Sale of Home D-2*
Scholarship and Fellowship Grants 21
S Corporations E-5*
Self-Employment Tax—
  Income Subject to SE-2*
  Deduction for One-Half of 30
Signing Your Return 53
Social Security and Equivalent Railroad
  Retirement Benefits 25–26
Social Security Number . . . . . 19 and 54
Standard Deduction or Itemized Deductions . 31–32
State and Local Income Taxes—Taxable
  Refunds, Credits, or Offsets of 22–23
Statutory Employees . . . . 21, C-2*, and C-6*
Student Loan Interest Deduction . . . 14 and 28–29

T

Tax and Credits 31–39
  Figured by the IRS . . . . . 33, 36, and 43
  Other Taxes—
    Alternative Minimum Tax . . . . 34 and 35
    Lump-Sum Distributions 25
    IRAs and Other Tax-Favored Accounts . . 39
    Recapture 40
    Section 72(m)(5) 40
    Self-Employment Tax SE-1*
Tax Computation Worksheet for
  Certain Dependents . . . . . 14 and 33
Tax Rate Schedules 71
Tax Table 59–70
Taxes You Paid A-2*
Taxpayer Advocate—Office of 6
Telephone Assistance—
  Federal Tax Information 11–13
  TeleTax Information 11–12
Terrorist Attacks—Victims of 14
Third Party Designee 53
Tip Income . . . . . 21 and 39
Tips Reported to Employer—Uncollected Tax on . 40
Trusts—Foreign B-2*

U

Unemployment Compensation 25
U.S. Citizens and Resident Aliens
  Living Abroad . . . . . 15 and 20

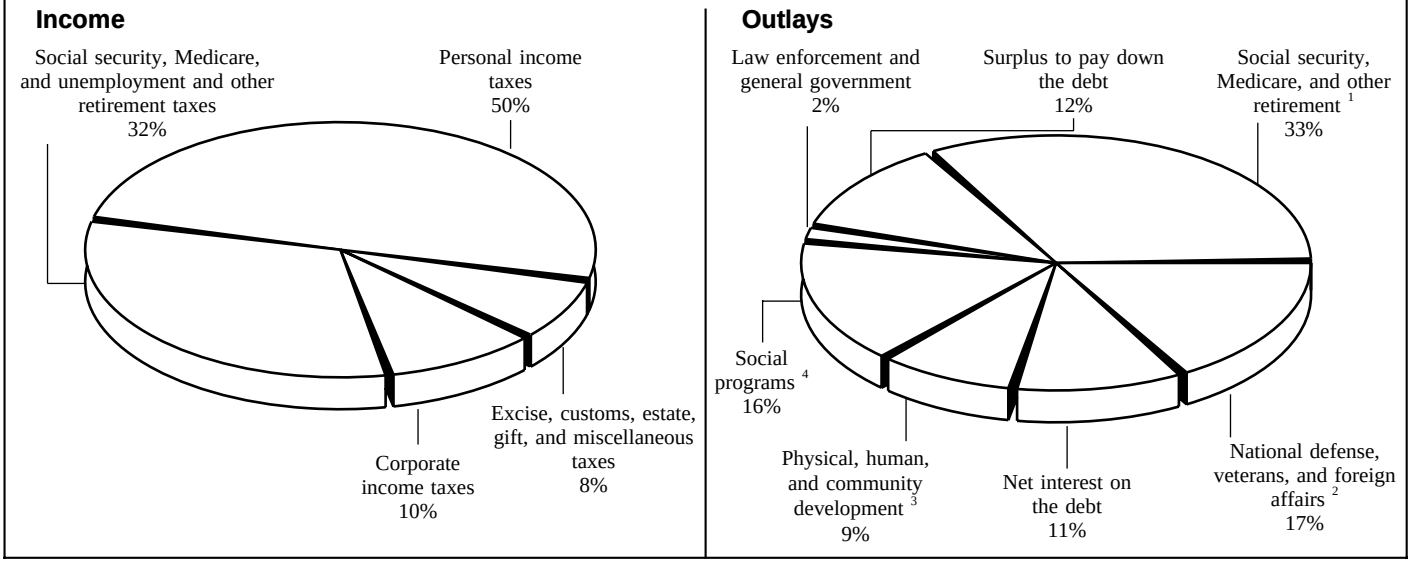
W

What if You Cannot Pay? . . . . . 13 and 52
When Should You File? 15
Where Do You File? . . . . . 15 and Back Cover
Who Must File 15–16
Who Should File 15
Widows and Widowers, Qualifying 19
Winnings—Prizes, Gambling, and Lotteries
  (Other Income) 27
Withholding—Federal Income Tax . . . 40 and 54

* These items may not be included in this package. To reduce printing costs, we have sent you only the forms you may need based on what you filed last year.

Major Categories of Federal Income and Outlays for Fiscal Year 2000

Income and Outlays. These pie charts show the relative sizes of the major categories of Federal income and outlays for fiscal year 2000.



On or before the first Monday in February of each year, the President is required by law to submit to the Congress a budget proposal for the fiscal year that begins the following October. The budget plan sets forth the President's proposed receipts, spending, and the surplus or deficit for the Federal Government. The plan includes recommendations for new legislation as well as recommendations to change, eliminate, and add programs. After receiving the President's proposal, the Congress reviews it and makes changes. It first passes a budget resolution setting its own targets for receipts, outlays, and the surplus or deficit. Next, individual spending and revenue bills that are consistent with the goals of the budget resolution are enacted.

In fiscal year 2000 (which began on October 1, 1999, and ended on September 30, 2000), Federal income was $2,025 billion and outlays were $1,789 billion, leaving a surplus of $236 billion.

Footnotes for Certain Federal Outlays

1. Social security, Medicare, and other retirement: These programs provide income support for the retired and disabled and medical care for the elderly.

2. National defense, veterans, and foreign affairs: About 14% of outlays were to equip, modernize, and pay our armed forces and to fund other national defense activities; about 2% were for veterans benefits and services; and about 1% were for international activities, including military and economic assistance to foreign countries and the maintenance of U.S. embassies abroad.

3. Physical, human, and community development: These outlays were for agriculture; natural resources; environment; transportation; aid for elementary and secondary education and direct assistance to college students; job training; deposit insurance, commerce and housing credit, and community development; and space, energy, and general science programs.

4. Social programs: About 11% of total outlays were for Medicaid, food stamps, temporary assistance for needy families, supplemental security income, and related programs; and 5% for health research and public health programs, unemployment compensation, assisted housing, and social services.

Note. The percentages on this page exclude undistributed offsetting receipts, which were $43 billion in fiscal year 2000. In the budget, these receipts are offset against spending in figuring the outlay totals shown above. These receipts are for the U.S. Government's share of its employee retirement programs, rents and royalties on the Outer Continental Shelf, and proceeds from the sale of assets.

Where Do You File?

If an envelope addressed to "Internal Revenue Service Center" came with this booklet, please use it. If you do not have one or if you moved during the year, mail your return to the Internal Revenue Service Center shown that applies to you.

TIP Envelopes without enough postage will be returned to you by the post office. Your envelope may need additional postage if it contains more than five pages or is oversized (for example, it is over ¼" thick). Also, include your complete return address.

IF you live in...	THEN use this address if you:	
	Are not enclosing a check or money order...	**Are enclosing a check or money order...**
Florida, Georgia, North Carolina, South Carolina, West Virginia	Internal Revenue Service Center Atlanta, GA 39901-0002	Internal Revenue Service Center Atlanta, GA 39901-0102
New Jersey, New York *(New York City and counties of Nassau, Rockland, Suffolk, and Westchester)*	Internal Revenue Service Center Holtsville, NY 00501-0002	Internal Revenue Service Center Holtsville, NY 00501-0102
New York *(all other counties)*, Massachusetts, Michigan, Rhode Island	Internal Revenue Service Center Andover, MA 05501-0002	Internal Revenue Service Center Andover, MA 05501-0102
Illinois, Iowa, Kansas, Minnesota, Missouri, Oklahoma, Utah, Wisconsin	Internal Revenue Service Center Kansas City, MO 64999-0002	Internal Revenue Service Center Kansas City, MO 64999-0102
Connecticut, Delaware, District of Columbia, Indiana, Maine, Maryland, New Hampshire, Pennsylvania, Vermont	Internal Revenue Service Center Philadelphia, PA 19255-0002	Internal Revenue Service Center Philadelphia, PA 19255-0102
Ohio	Internal Revenue Service Center Cincinnati, OH 45999-0002	Internal Revenue Service Center Cincinnati, OH 45999-0102
Arizona, Colorado, Idaho, Montana, New Mexico, Texas, Wyoming	Internal Revenue Service Center Austin, TX 73301-0002	Internal Revenue Service Center Austin, TX 73301-0102
Nebraska, North Dakota, South Dakota, Washington	Internal Revenue Service Center Ogden, UT 84201-0002	Internal Revenue Service Center Ogden, UT 84201-0102
Alaska, California, Hawaii, Nevada, Oregon	Internal Revenue Service Center Fresno, CA 93888-0002	Internal Revenue Service Center Fresno, CA 93888-0102
Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Tennessee, Virginia	Internal Revenue Service Center Memphis, TN 37501-0002	Internal Revenue Service Center Memphis, TN 37501-0102
All APO and FPO addresses, American Samoa, nonpermanent residents of Guam or the Virgin Islands*, Puerto Rico *(or if excluding income under Internal Revenue Code section 933)*, a foreign country: U.S. citizens and those filing Form 2555, 2555-EZ, or 4563	Internal Revenue Service Center Philadelphia, PA 19255-0215 USA	Internal Revenue Service Center Philadelphia, PA 19255-0215 USA

* Permanent residents of Guam should use: Department of Revenue and Taxation, Government of Guam, P.O. Box 23607, GMF, GU 96921; permanent residents of the Virgin Islands should use: V.I. Bureau of Internal Revenue, 9601 Estate Thomas, Charlotte Amalie, St. Thomas, VI 00802.

What's Inside?

Instructions for Form 1040
Index (inside back cover)
When to file (page 15)
What's new for 2001 (page 14)
Commissioner's message (page 2)
How to comment on forms (page 72)
How to avoid common mistakes (page 54)
Help with unresolved tax issues (page 6)
Free tax help (pages 7 and 56)
How to get forms and publications (page 7)
Tax table (page 59)
How to make a gift to reduce the public debt (page 54)