TAX DEPOSITION QUESTIONS: 11. TAXABLE SOURCES

11. TAXABLE SOURCES

Introduction

As written, the statutes in the U.S. Codes (U.S.C.) say to use regulations connected to 26 U.S.C. Section 861 to determine if income is taxable. Per the plain language of the regulations, "Items" of income can only be taxed if they come from taxable "sources." The list of "sources", which is the same word as found in the 16th Amendment, is found in Section 861.

The list of these "sources" found at Section 861 is limited to foreign source income and foreign taxpayers. Again, per the plain language of the regulations, "wages", salaries and even capital gains earned by Americans Nationals (but not "citizens") domiciled within the fifty states are not taxable.

The IRS does not want you to look at Section 861, which is why the regulations that implement it are so badly obfuscated to confuse people.

NOTE: *These questions were not asked at the Hearing due to time limitations. No video testimony or transcript is available. We also do not suggest using these arguments in your own tax litigation.*

Findings and Conclusions

With the following series of questions, we intend to prove that the average American has no "income" as constitutionally defined, no income from taxable sources within the "United States", and therefore no liability to file a return. We will also show that:

- **As written, the statutes in the U.S. Codes (U.S.C.) instruct tax payers to use regulation Section 861 to determine if their income is taxable.**
- **Deletions and alterations of key phrases and references since 1954 have deliberately induced confusion in this portion of the tax code which determines what income is taxable.**
- **Per the plain language of the regulations, "Items" of income can only be taxed if they come from taxable "sources."**
- **The list of "sources", which uses the same word "source" as found in the 16th Amendment, is found in Section 861.**
- **The list of "sources" found at Section 861 is limited to foreign source income and foreign taxpayers/corporations.**
- **Per the plain language of the regulations, wages, salaries and even capital gains earned by ordinary Americans within the fifty states are not taxable.**

Bottom Line: The IRS does not want you to look at Section 861.

Section Summary

Acrobat version of this section including questions and evidence (large: 5.76 MBytes)

Further Study On Our Website:

- "IRC 861: Income Tax or Source Tax?"-Antishyster Magazine, Vol. 11, No. 2
- "IRC 861: What is the Source of Your Income?"-Antishyster Magazine, Vol. 11, No. 2
- Great IRS Hoax book:
    - Section 5.1.1: What Type of Tax are you Paying the IRS: Direct or Indirect?
    - Section 5.1.2: SURPRISE!: The Income Tax is a MANDATORY INDIRECT EXCISE Tax or a VOLUNTARY DIRECT DONATION
    - Section 5.3: Know Your Proper Income Tax Filing Status
    - Section 5.6.6: The Definition of "income" for the purposes of income taxes
    - Section 5.6.11: The 861 "Source" Position

11.1. Admit that the term "from whatever source derived" as used in the Sixteenth Amendment does *not* mean that the source of income or the situs for taxation is *irrelevant or inconsequential in determining taxable income*. (WTP #442)

- Click here for the Sixteenth Amendment

11.2. Admit that interpreting the phrase "from whatever source derived" to mean that the source or situs is irrelevant, makes the federal income tax applicable to any country or location in the world and renders 26 U.S.C. §861 and 26 U.S.C. §862 irrelevant and unnecessary, which clearly is an irrational and nonsensical conclusion to reach. (WTP #443)

- Click here for 26 U.S.C. §861
- Click here for 26 U.S.C. §862

11.3. Admit that the federal income tax under I.R.C. Subtitle A applies only to taxable income, which, generally speaking, is "gross income" minus allowable deductions. (WTP #444)

> *TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter N > PART I > § 863*
> *§ 863. Special rules for determining source*
>
> *(a) Allocation under regulations Items of gross income, expenses, losses, and deductions, other than those specified in sections 861 (a) and 862 (a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.*

11.4. Admit that the federal income tax regulations 26 CFR Part 1, generally define "gross income" to mean "all income from whatever source derived, unless excluded by law." as follows: (WTP #445)

> *26 CFR § 1.61-1(a):*
>
> *(a) General definition. Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of*

illustration. For purposes of further illustration, Sec. 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

- Click here for 26 CFR. §1.61-1

11.5. Admit that there are certain types of income which Congress has exempted by statute as identified in 26 CFR §1.61-1(a). (WTP #446)

- Click here for 26 CFR. §1.61-1

11.6. Admit that there are other types of income not enumerated above which are not exempted by statute, but are nonetheless "excluded by law", for income tax purposes, because they are excluded from taxation by the Constitution itself or because not specifically identified as "gross income" somewhere in the Internal Revenue Code. (WTP #447)

26 CFR § 39.21-1 (1956):

(a) The tax imposed by chapter 1 is upon income. Neither income exempted by statute *<u>or fundamental law</u>**, nor expenses incurred in connection therewith, other than interest, enter into the computation of net income as defined by section 21.*

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26 CFR § 39.22(b)-1 (1956):

Certain items of income specified in section 22(b) are exempt from tax and may be excluded from gross income. These items, however, are exempt only to the extent and in the amount specified. No other items may be *<u>excluded from gross income</u>* *except (a) those items of income which are,* *<u>under the Constitution, not taxable by the Federal Government</u>**; (b) those items of income which are exempt from tax on income under the provisions of any act of Congress still in effect; and (c) the income excluded under the provisions of the Internal Revenue Code (see particularly section 116).*

11.7. Admit that the phrase "fundamental law" indicated above in the older regulations means the U.S. Constitution. (WTP #448)

Federalist Paper #78, Alexander Hamilton

The interpretation of the laws is the proper and peculiar province of the courts. ***<u>A constitution is, in fact, and must be regarded by the judges, as a fundamental law.</u>*** *It therefore belongs to them to ascertain its meaning, as well as the meaning of any particular act proceeding from the legislative body. If there should happen to be an irreconcilable variance between the two, that which has the superior obligation and validity ought, of course, to be preferred; or, in other words, the Constitution ought to be preferred to the statute, the intention of the people to the intention of their agents.*

11.8. Admit that the above older regulation, 26 CFR §39.21-1 (1956) and 26 CFR § 39.22(b)-1 (1956) has never been explicitly repealed or superseded by newer regulations and is still in force. (WTP #449)

11.9. Admit that the regulations under 26 U.S.C. §863 state: (WTP #450)

26 CFR § 1.863-1(c)

*"**Determination of taxable income**. The taxpayer's taxable income from sources **within or without** the United States **will be determined under the rules of Secs. 1.861-8 through 1.861-14T** for determining taxable income from sources **within** the United States."*

- Click here for 26 CFR. §1.863-1

11.10. Admit that 26 U.S.C. § 61 lists some of the more common "classes of gross income" which may possibly be taxable, such as compensation for services, interest, and dividends, among others and admit that section 1.861-8(d)(2) of the federal income tax regulations are to be consulted in determining in which situations these "classes of gross income" are excluded for federal income tax purposes? (WTP #451)

26 CFR § 1.861-8(d)(2)

(2) Allocation and apportionment to exempt, excluded, or eliminated income. [Reserved] For guidance, see Sec. 1.861-8T(d)(2).

- Click here for 26 CFR. §1.861-8

11.11. Admit that 26 CFR § 1.861-8T(d)(2) of the regulations lists several types of income which are, quote, not considered to be exempt, eliminated, or excluded income, end quote as follows: (WTP #452)

26 CFR § 1.861-8T(d)(2)(iii)

(iii) Income that is not considered tax exempt. The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:
(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;
(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;
(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and
(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of Sec. 1.911-6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

- Click here for 26 CFR. §1.861-8T

11.12. Admit that only "income" derived from certain activities related to international or foreign commerce are included on that list of non-exempt types of income appearing in 26 CFR § 1.861-8T(d)(2)(iii) above. (WTP #453)

- Click here for 26 CFR. §1.861-8T

11.13. Admit that the "income" of most American Nationals (but not "citizens") domiciled in the states is absent, and therefore excluded, from the list appearing in 26 CFR § 1.861-8T(d)(2)(iii). (WTP #454)

- Click here for 26 CFR. §1.861-8T

11.14. Admit that 26 U.S.C. § 861(b), and the related regulations beginning at 26 CFR § 1.861-8, are the sections to use to determine one's taxable income from "sources within the United States", regardless of citizenship and residency. (WTP #455)

- Click here for 26 U.S.C. §861
- Click here for 26 CFR. §1.861-8

11.15. Admit that for American Nationals (but not "citizens") living and working exclusively in the 50 states and receiving all earnings from within the 50 states, that 26 U.S.C. §861(b) and related regulations beginning at 26 CFR §1.861-8 do not classify such earnings to be taxable. (WTP #456)

- Click here for 26 U.S.C. §861
- Click here for 26 CFR. §1.861-8

11.16. Admit that "classes of gross income" are defined in 26 CFR §1.861-8(a)(3) and are identified in 26 U.S.C. §61.

11.17. Admit that "items of income" of income are defined in 26 CFR §1.861-1(a) and are identified in 26 U.S.C. §861 through 26 U.S.C. §863.

QUESTIONS ADDED BY AUTHOR BEYOND ORIGINAL WE THE PEOPLE HEARING

11.18. Admit that "operative sections" are defined in 26 CFR §1.861-8(a)(1) and 26 CFR §1.861-8(f)(1).

- Click here for 26 CFR §1.861-8

11.19. Admit that to be "gross income", monies must derive from an "operative section" defined in 26 CFR §1.861-8(a)(1) and 26 CFR §1.861-8(f)(1).

- Click here for 26 CFR §1.861-8

11.20. Admit that the only "operative sections" identified in 26 CFR §1.861-8(a)(1) and 26 CFR §1.861-8(f)(1) are 26 U.S.C. §871(b), 26 U.S.C. §882, and 26 U.S.C. §904(a).

- Click here for 26 CFR §1.861-8

11.21. Admit that 26 U.S.C. §871(b) deals only with nonresident aliens engaged in a "trade or business" within the "United States".

- Click here for 26 U.S.C. §871

11.22. Admit that 26 U.S.C. §882 deals only with "Taxes on income of foreign corporations connected with United States Business".

- Click here for 26 U.S.C. §882

11.23. Admit that 26 U.S.C. §904(a) deals only with "Limitations on credit" taken under 26 U.S.C. §901(a), which then deals with "taxes on foreign countries and of possessions of the United States".

- Click here for 26 U.S.C. §904
- Click here for 26 U.S.C. §901

11.24. Admit that before monies can be called "gross income", they must *first* be classified as "income" in a Constitutional sense.

11.25. Admit that in the case of Eisner v. Macomber, 252 U.S. 189 in 1920, the U.S. Supreme Court ruled that Congress cannot by legislation define or redefine the term "income" because only the Constitution can define it.

> *"In order, therefore, that the [apportionment] clauses cited from article I [§2, cl. 3 and §9, cl. 4] of the Constitution may have proper force and effect …[I]t becomes essential to distinguish between what is an what is not 'income,'…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 those limitations alone that power can be lawfully exercised****… [pg. 207]…After examining dictionaries in common use 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] and* **Doyle v. Mitchell Bros. Co.***, 247 U.S. 179, 185, 38 S.Sup.Ct. 467, 469, 62 L.Ed. 1054…"*

- Click here for Eisner v. Macomber, 252 U.S. 189 (1920)

11.26. Admit that the only definition of the term "income" in Title 26, the Internal Revenue Code, is found in 26 U.S.C. §643 as follows.

> ***TITLE 26*** *>* ***Subtitle A*** *>* ***CHAPTER 1*** *>* ***Subchapter J*** *>* ***PART I*** *>* ***Subpart A*** *> § 643*
> *§ 643. Definitions applicable to subparts A, B, C, and D*
>
> *(b)* ***Income***
>
> *For purposes of this subpart and subparts B, C, and D,* ***the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.*** *Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.*

- Click here 26 U.S.C. §643

11.27. Admit that the term "income" was defined by the U.S. Supreme Court to mean "corporate profit".

> *"…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)*

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

"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)

11.28. Admit that the term "income" means the same thing in Corporate Excise Tax of 1909 as it meant in the Sixteenth Amendment and all revenue acts subsequently passed.

"Income has been taken to mean the same thing as used in the Corporation Excise Tax Act of 1909 (36 Stat. 112) in the 16th Amendment, and in the various revenue acts subsequently passed." [Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, 174, (1926)]

11.29. Admit that the taxable sources listed in 26 CFR §1.861-8(f)(1) contain only "income" as constitutionally defined.

- Click here for 26 CFR §1.861-8

11.30. Admit that in the case of Stanton v. Baltic Mining, 240 U.S. 103 in 1916, Congress identified the income tax as an "indirect" tax and stated that "the 16th Amendment conferred no new powers of taxation".

"But, aside from the obvious error of the proposition, intrinsically considered, it manifestly disregards the fact that, ***by the previous ruling, it was settled that the provisions of the Sixteenth Amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged****, and being placed [240 U.S. 113] in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived -- that is, by testing the tax not by what it was, a tax on income, but by a mistaken theory deduced from the origin or source of the income taxed."*

- Click here for Stanton v. Baltic Mining, 240 U.S. 103 (1916)

11.31. Admit that income taxes are all uniformly classified as excise taxes according to the U.S. Supreme Court in ***Brushaber v. Union Pacific Railroad***, 240 U.S. 1 (1916).

"...the conclusion reached in the *Pollock* case did not in any degree involve holding that income taxes generically and necessarily came within the class [240 U.S. 17] of direct taxes on property, but, on the contrary, recognized the fact that taxation on ***income was in its nature an excise entitled to be enforced as such*** unless and until it was concluded that to enforce it would amount to accomplishing the result which the requirement as to apportionment of direct taxation was adopted to prevent, in which case the duty would arise to disregard form and consider substance alone, and hence subject the tax to the regulation as to apportionment which otherwise as an excise would not apply to it."

- Click here for Brushaber v. Union Pacific Railroad, 240 U.S. 1 (1916)

"...a tax on incomes cannot properly be classified as a property tax, but falls in the class of excise taxes."

- Click here for Sims v. Ahrens, 271 S.W. 720 (1925)

11.32. Admit that excise taxes are taxes that are imposed on those entities in receipt of privileges, according to the U.S. Supreme Court in the case of ***Flint v. Stone Tracy***, 220 U.S. 107 (1916).

"***Excises are taxes laid upon the manufacture, sale or consumption of commodities within the country, upon licenses to pursue certain occupations and upon corporate privileges***...***the requirement to pay such taxes involves the exercise of*** **[220 U.S. 107, 152]** ***privileges, and the element of absolute and unavoidable demand is lacking***...

It is therefore well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is nontaxable.

Conceding the power of Congress to tax the business activities of private corporations.. the tax must be measured by some standard..." ***Flint v. Stone Tracy***, 220 U.S. 107 (1916)

- Click here for Flint v. Stone Tracy, 220 U.S. 107 (1911)

11.33. Admit that corporations are in receipt of privileges by virtue of their existence as an artificial legal entity.

11.34. Admit that entities other than federal corporations can *volunteer* to become liable for an excise tax for which they aren't technically or legally liable by identifying themselves as officers or agents of a privileged federal corporation.

[Code of Federal Regulations]
[Title 26, Volume 17, Parts 300 to 499]
*[Revised as of April **1**, 2000]*
From the U.S. Government Printing Office via GPO Access
*[**CITE: 26CFR301.6671-1**]*
TITLE 26--INTERNAL REVENUE
Additions to the Tax and Additional Amounts--Table of Contents

*Sec. 301.**6671-1** Rules for application of assessable penalties.*

(b) Person defined. For purposes of subchapter B of chapter 68, ***the term ``person'' includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs***.

11.35. Admit that a person engaged in a "trade or business" is engaged in an excise taxable voluntary activity defined in 26 U.S.C. §7701(a)(26) as "the functions of a public office".

26 U.S.C. Sec. 7701 Definitions

(a)(26) *"The term 'trade or business' includes the performance of the functions of a public office."*

11.36 Admit that the United States government is a federal corporation:

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.

11.37 Admit that a "person" engaged in a "trade or business" as a "public officer" in the "United States" makes that person an "officer of a corporation" who fits the description of "person" found in 26 U.S.C. §6671(b) and 26 U.S.C. §7343.

TITLE 26 > Subtitle F > CHAPTER 68 > Subchapter B > PART I > § 6671
§ 6671. Rules for application of assessable penalties

(b) Person defined
The term "person", as used in this subchapter, includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

TITLE 26 > Subtitle F > CHAPTER 75 > Subchapter D > Sec. 7343.
Sec. 7343. - Definition of term "person"

The term "person" as used in this chapter [Chapter 75] includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs

*[**NOTE**: This is the "person" for the purposes of some of the **miscellaneous penalties** under the Internal Revenue Code]*

11.38. Admit that the word "tax" as legally defined *does not* include monies donated or volunteered for which the payer is not liable or is not engaged in the privileged activity subject to tax.

"Tax: *A charge by the government on the income of an individual, corporation, or trust, as well as the value of an estate or gift. The objective in assessing the tax is to generate revenue to be used for the needs of the public.*

A pecuniary [relating to money] burden laid upon individuals or property to support the government, and is a payment exacted by legislative authority. In re Mytinger, D.C.Tex. 31 F.Supp. 977,978,979. ***Essential characteristics of a tax are that it is NOT A VOLUNTARY PAYMENT OR DONATION, BUT AN ENFORCED CONTRIBUTION, EXACTED PURSUANT TO LEGISLATIVE AUTHORITY.*** *Michigan Employment Sec. Commission v. Patt, 4 Mich.App. 228, 144 N.W.2d 663, 665. ..."*

- Click here for a definition of the word "tax" from Black's Law Dictionary, Sixth Edition, page 1457

11.39. Admit that because monies paid voluntarily cannot legally be classified as "taxes", then they are more properly classified as "donations"

"Donatio: A gift. A transfer of the title of property to one who receives it without paying for it. The act by which the owner of a thing ***voluntarily transfers*** *the title and possession of the same from himself to another person, without any consideration."*

- Click here for a definition of the word "donation" from Black's Law Dictionary, Sixth Edition, page 487

11.40. Admit that Dwight E. Avis, former head of the Alcohol and Tobacco Tax Division of the IRS, testifying before a House Ways and Means subcommittee in 1953, said the following:

"Let me point this out now. Your income tax is 100 percent voluntary tax, and your liquor tax is 100 percent enforced tax. Now, the situation is as different as night and day. Consequently, your same rules just will not apply...".

- Click here for evidence of Mr. Avis' testimony

11.41. Admit that American Nationals who are not "liable" but pay money anyway under Subtitle A of the Internal Revenue Code cannot properly be said to be paying a "tax", but a "donation" based on the legal definition of "tax" presented above.

11.42. Admit that the IRS routinely referring to "donations" as "taxes" could lead an educated and reasonable person to believe that a constructive fraud is being committed.

11.43. Admit that the result of such a constructive fraud, if it exists, is called "theft by deception".

11.44. Admit that specific sources or activities subject to tax under the Sixteenth Amendment are identified in 26 CFR 1.861-8(f)(1).

- Click here for 26 CFR §1.861-8

11.45. Admit that all of the taxable sources listed in 26 CFR 1.861-8(f)(1) are directly or indirectly derived from corporations in one form or another, including a "trade or business".

11.46. Admit that the types of corporations identified in 26 CFR 1.861-8(f)(1) which are subject to tax are foreign corporations, including Foreign Sales Corporations (FSC) and Domestic International Sales Corporations (DISC).

11.47. Admit that the taxable sources identified in 26 CFR 1.861-8(f)(1) relate to foreign commerce coming under Article 1, Section 8, Clause 1 and Article 1, Section 8, Clause 3 of the U.S. Constitution.

- Click here for Article 1 of the U.S. Constitution

11.48. Admit that foreign and interstate commerce are the only types of commerce which Congress is authorized to regulate relating to states of the Union Article 1, Section 8 of the U.S. Constitution.

11.49. Admit that foreign commerce is the only type of taxable source identified in 26 CFR 1.861-8(f)(1).

- Click here for 26 CFR §1.861-8

11.50 Admit that the term "foreign" is only defined once in the Internal Revenue Code, and only in the context of "corporations".

> *United States Code*
> *TITLE 26 - INTERNAL REVENUE CODE*
> *SUBTITLE F - PROCEDURE AND ADMINISTRATION*
> *CHAPTER 79 - DEFINITIONS*
> *Section 7701. Definitions*
>
> *(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof -*
>
> *[. . .]*
>
> *(5) Foreign*
>
> *The term ''foreign'' when applied to a corporation or partnership means a corporation or partnership which is not domestic.*

11.51 Admit that the term "domestic" is nowhere defined in the Internal Revenue Code or the Treasury Regulations.

11.52 Admit that the absence of definitions of the terms "foreign" and "domestic" in the context of natural persons within the I.R.C. makes it difficult, if not impossible, for the average American National to easily determine from written law whether he or she has income from sources that are "domestic".

11.53 Admit that the term "United States" as used under Subtitle A of the Internal Revenue Code is defined as follows and not expanded anywhere else in that context to include any other place:

> *TITLE 26 > Subtitle F > CHAPTER 79 > Sec. 7701. [Internal Revenue Code]*
> *Sec. 7701. - Definitions*
>
> *(a)(9) United States*
>
> *The term ''United States'' when used in a geographical sense includes only the States and the District of Columbia.*
>
> *(a)(10)The term ''State'' shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.*

11.54 Admit that all income originating from the "United States", as defined above, is "domestic" income within the meaning of Subtitle A of the Internal Revenue Code.

SECTION 11-TAXABLE SOURCES SUMMARY

Note: These questions were not asked during the hearing due to time constraints.

Research Hint: For the definitive discussion of this complex but compelling topic, please visit Larkin Rose's website at www.taxableincome.net

Subtitle A income taxes under the Internal Revenue Code are indirect excise taxes as ruled by the Supreme Court.

Indirect excise taxes are taxes on privileges and are triggered by the happening of a taxable privileged activity or event, such as the sale of a commodity. If you don't want to pay an excise tax, then don't do the activity that is taxed. This is the essence of why excise taxes are considered to be voluntary taxes.

"income" as defined by the U.S. Supreme Court means *only* corporate profit.

Taxable income means gross income minus deductions.

Before one can earn gross income, one must earn "income", which is corporate profit.

The 16th Amendment (purportedly) gives the government to tax income "from whatever source derived." The IRS would have us believe that this means that income that comes from ANY source, whatever, wherever, whenever, is subject to the income tax.

In fact this is simply not true. The IRS regulations under Section 861 of the Internal Revenue Code regulations contain a list of "specific sources" that are considered to be gross income. Anything else not in the list of specific sources is not considered to be gross income and is therefore not subject to the income tax under Subtitle A of the Internal Revenue Code.

Specific sources subject to tax under the Sixteenth Amendment derive from "operative sections" of the code, which are statutes that identify *specific* activities and sources that trigger the excise tax known as the income tax.

The easiest way to frame the taxable sources subject is this: There are many types of monies earned (wages, salaries, dividends, rents, capital gains, etc.). But for any of these earnings are to be taxed, they must first come from a "taxable source" – i.e. a "source" or taxable activity that the IRS has legal jurisdiction to impose an excise tax on.

In tax code parlance, we cannot have "taxable income" until we have "gross income", and we can't have "gross income" until we have "income", which means corporate profit.

The evidence will show that decades old versions of the tax code made it quite clear which types of earnings were exempt from classification as "gross income". As the years progress, this language has been systemically removed from the code and the regulations to increase the likelihood that readers will not consider that some income is automatically exempt via the Constitution, regardless of what is listed in the regulations.

In fact, in numerous places in the tax code the plain language of the regulations point specifically to Section 861 to determine if income is taxable or not. The IRS contends in its publications that this Section does not apply to income earned in the U.S. but simultaneously will not directly answer the straightforward question about whether 861 is the Section to determine taxable income or not.

The IRS refuses to directly address this issue and even has the Courts now fining People for daring to ask what the written law means. Regardless of what the IRS says – this issue has NEVER been directly adjudicated in U.S. District Court. All legal cites the IRS gives are Tax Court cases, which as we have seen have no general applicability to the public and by law, cannot even cited by the IRS as precedent.

In short, the regulations under IRS section 861 plainly reveal that monies earned by most ordinary Americans are not taxable, because they do not come from a specific taxable source.

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"Income" Tax ~~or~~ "Source" Tax?

by Alfred Adask

The tax "avoidance" movement has recently produced a hot, refined versions of the "861" defense. This defense argues that under Section 861 of the IRS Code (26 USC 861), most income *sources* are not subject to an income tax.

Roughly speaking, research (going all the way back to 1916 original income tax laws) indicates that if the "source" of your income is a transaction involving "alcohol, tobacco, firearms" and few other privileged activities, then you are obligated to pay income tax on earnings derived from those activities. On the other hand, if the *source* of your income is ordinary, non-privileged economic activity (like carpentry, running a day care center or managing a sole proprietorship), your earnings are not subject to income taxation. In other words, a lawful income tax is not imposed directly on the *people*, or even on their "income," but rather on the *sources* of their income. Some sources are taxable, other sources are not.

If the 861 argument is correct, it implies that 95% of American workers have no duty to pay income tax since their income is not derived from privileges "sources".

Another "frivolous" argument?

As often happens with "patriot" arguments, the "861 defense" seems too good to be true. If the income tax was only intended to apply to those few people engaged in *privileged* activities (like the production of alcohol, tobacco and firearms)—but had no lawful application to the other 95% of American workers who earned their livings from ordinary, non-privileged "sources"—how could government have tricked the other 95% into paying?

One explanation involves the Victory Tax imposed during World War II. That tax asked the American workers to voluntarily contribute a portion of their weekly pay for two years to help win the war against Germany and Japan. The Victory tax also asked employers to voluntarily collect their workers' contributions and forward those contributions to the national government. Thus, the Victory Tax gave average Americans their first taste of "withholding"—the idea that workers would voluntarily contribute and employers would voluntarily collect a portion of their weekly incomes and send it to Washington.

The Victory Tax was intended to last for just two years. But two years, and then two decades came and went, and the tax intended to win WWII continued to be collected long after the war ended and even after we'd reestablished alliances with our former enemies.

It's easy to imagine how all patriotic Americans—wanting to help win WWII—would agree to voluntarily contribute a portion of their income as "taxes" even though their incomes were not lawfully taxable. It's likewise easy for cynics (or realists, depending on your point of view) to imagine that self-serving government would take advantage of patriotic Americans' and continue to demand their financial "contributions" long after the original purpose for those contributions had disappeared.

Most people can't believe our government could defraud the American people. Even if you're willing to concede that *government* might be that greedy, unlawful and prone to extortion—you still have to accept the astonishing belief that the American *people* were fool enough to allow themselves to be tricked into such an incredible deception. Is it really possible that the American people could be that *dumb*?

Seems so. To paraphrase P.T. Barnum, "There's a voter born every minute."

The implications are depressing. If Americans are that gullible, what faith could we place in the idea of "democracy"? If Americans can be tricked for over half a century into paying an income tax that has no foundation in law, then you have to admit the average American is so ignorant that his "informed" votes are only marginally superior to the votes of most monkeys.

Nuthin' up my sleeve (or in the statutes, either)

However, if the 861 "source of income" defense is valid, then government's unlawful application of income tax can be easily stopped. After all, if government actually *tricked* us into paying income taxes on "sources" which aren't lawfully taxable, then it follows that there must be no underlying law to justify those taxes. In other words, why would government resort to *trickery* if the relevant law actually exists?

This question implies an important axiom: Whenever you find evidence of governmental deception, it almost certainly means there is no relevant underlying law. Thus, if you can learn to identify the government's lies and deceptions, that identification may constitute a "get out of jurisdiction free" card.

Further, once government starts a deception (and there's no underlying law), it's unlikely that government will later pass a relevant law. Once the deception starts, going back and changing the law would not only admit the deception, it might even provoke folks to wake up, vote intelligently, and possibly return to the pre-WWII condition where most Americans paid no income tax.

My point is that *if* government has imposed the income tax on most Americans through trickery since 1943, it's a virtual certainty that there's still *no law* to support that taxation.

And that's exactly what the Section 861 defense contends. There is *no law* declaring that the vast majority of American's incomes are derived from taxable sources.

Will the 861 defense work?

I don't know.

But I do know and respect the judgment of several researchers who claim the 861 defense is hot and valid.

More importantly, I know that (so far) government has shrieked that the 861 argument is flawed, impossible, and contrary to common sense. They've raised clouds of dust, smoke and a host of mirrors to discredit the 861 argument. But (so far) government has not issued a persuasive denial of the 861 "sources" argument based on nothing more than existing statutes and case law. I am persuaded that the 861 defense is valid because (so far) government's done nothing to deny that defense but scream like a wounded animal.

Reclamation now!

And I can see why government would scream. If the 861 defense works, it won't merely allow people to *stop* paying income tax—it will allow them to *reclaim* income taxes paid to Washington for at least the *last three years*. Those trying to reclaim previously paid taxes reportedly file *amended* tax returns that indicate the previously paid taxes were paid by *mistake*. They claim they didn't know the *source* of their income was not taxable, and therefore (Dear Mr. Taxman), would you please send a refund in full?

This tax reclamation movement is not confined to impoverished tax resistors. At least one Hollywood movie star is trying to employ the 861 argument to regain $24 million in taxes paid over the last three years. Can you imagine what will happen if that movie star wins? The publicity will be unstoppable and the cat will be absolutely out of the IRS's bag.

Imagine how many people would file amended income tax returns if they thought they could regain all the money they paid to the IRS over the last *three* years. For the average person, that might amount to half a year's pay. I'd say that's a serious incentive.

Caveat emptor

The 861 defense isn't new. Reportedly, it's been used before and defeated. What is new is the depth of research that's gone into making "new and improved" 861 arguments. Some researchers have traced the relevant law all the way back to 1916.

Nevertheless, if you choose to use the 861 sources strategy, be cautious. Make sure that whatever strategy you employ is based on a complete analysis of IRC Section 861 and *all* underlying law and federal regulations.

More importantly, recognize that if the 861 strategy is valid, it will *destroy* the IRS. That means that the IRS will fight tooth and nail to ignore, refute or defeat anyone who tries to use this strategy. For the IRS, the 861 "source of income" argument may be a "life or death" issue. That being so, the IRS can be expected use any means available—within the law or otherwise—to not only defeat but *punish* anyone attempting to use this strategy.

Time will tell whether the 861 strategy is valid or flawed. I recommend that anyone concerned with income taxes start studying the 861 strategy now with the intention of possibly applying it six months from now. By then, the validity of this strategy should be obvious to all.

For now, I can't say I'm not absolutely convinced that they Section 861 "sources of income" argument is valid, but everything suggests that this strategy may be explosive.

The next article is written by Larken Rose, a principal in the research and propagation of the 861 defense. His article offers a more technical foundation for understanding the 861 defense.

What's the "Source" of Your Income?

by Larken Rose
http://www.taxableincome.net

This article consists of two parts: 1) a letter from Mr. Rose to the Attorney General of the United States; and 2) a document entitled "Legal Basis for Not Filing / Not Paying" which explains some the letter's fundamental principles.

The letter offers a general overview of the confusion caused by the IRS Code as well as a reasonable person's resulting conclusions. You'll see why some folks refuse to automatically comply with the IRS Code . . . it's simply too unclear, ambiguous and seemingly contradictory to be easily understood or rationally obeyed.

The "Legal Basis for Not Filing / Not Paying" is more technical and intellectually challenging. If you're serious about learning the 861 "sources" defense, you'll want to study the "Legal Basis" article. If your interest in tax law is less intense, you might want to read the letter but skip the highly technical "Legal Basis" attachment. But even though the "Legal Basis" is hard to follow, it presents the bones of a very hot defense. No pain, no gain, hmm?

March 6, 2001
John Ashcroft, Attorney General
U.S. Department of Justice
950 Pennsylvania Avenue, NW
Washington, DC 20530-0001

Dear Mr. Ashcroft,

Though my wife and I run a small business, and receive income from that business, 1996 was the last year for which we filed a federal income tax return or made any federal income tax payments.

While in the past I had always believed the federal income tax to be immoral and unconstitutional, we did not stop paying in "protest" of any law. On the contrary, we stopped filing and paying because we took the time to examine the *law itself*, to determine what it required of us. After extensive personal research, I came to a rather disturbing conclusion:

While the federal income tax is entirely valid and Constitutional, it does not apply to the income of most Americans. I do not just mean it *cannot* apply to such income; I mean the law itself shows that it *does* not apply to such income. During my research into the law, not only did I find abundant evidence proving my conclusions, from the actual federal income tax statutes and regulations (past and present), but I also believe I have substantial documentation proving an ongoing and deliberate attempt by some in the federal government to conceal the truth, and to intentionally deceive and defraud the American public.

"*Thou shalt not steal.*" "*Thou shalt not bear false witness.*" I trust that you believe that these statements apply to agents of the United States government, and I hope you do not believe that political power or the "compelling interest" of the state supersede those commands. The organization over which you now preside has participated (whether knowingly or not) in the biggest extortion racket in the history of mankind.

The enforcers of the law, both at the IRS and at the DOJ, have been enforcing a *non-existent* law when they demand income tax returns and payments from United States citizens who live and work exclusively within the 50 states, and when those agents harass and persecute such citizens when they do not "comply." Ironically, the victims of this injustice usually *assume* that they have broken the law. However, the fact that people have *attempted* to evade a tax is only legally relevant if a tax was actually *owed*. (False assumptions and erroneous "conventional wisdom" do not create legal obligations.)

> "The United States Attorney. . . is in a peculiar and very definite sense the servant of the law, the twofold aim of which is that guilt shall not escape *or innocence suffer* . . . It is as much his duty to *refrain from improper methods calculated to produce a wrongful conviction* as it is to use every legitimate means to bring about a just one." *Berger v. United States*, 295 U.S. 78 (1935)

I am no fan of lawyers per se, but I believe prosecutors have a tendency to be more honest, more driven by principle, and have more interest in having justice be served than in winning every case at all costs. I would guess that most U.S. attorneys who prosecute individuals for "failure to file" or "tax evasion" are under the impression that they are simply enforcing the law, and punishing those who are intentionally avoiding their legal responsibilities. Ironically, the defendants probably believe the same. However, in the majority of cases, both are mistaken.

I am enclosing a brief summary of the legal basis for my decision not to file or pay, as well as a more in-depth explanation of the results of my research—a report entitled "Taxable Income" (10/23/00 revision)—which documents the strictly *limited* application of the federal income tax. I am well aware of the many unfounded "tax protestor" theories which are based upon "creative interpretation" or twisted logic, and I agree that many such arguments are "frivolous" and without merit. My findings, in contrast, are based entirely on what the federal income tax statutes and regulations *themselves* say (and have said since long before I was born).

However, I did not stop at what I saw in the statutes and regulations. After reaching my conclusions, I *sought out* opposing views; I have repeatedly attempted to get government officials, including IRS officials, to refute what I have found, to show me where I may have made a mistake.

While many have *asserted* that my conclusions are incorrect, they produced no *evidence* to support that assertion. In fact, the so-called "experts" have routinely contradicted *each other* when trying to explain away the many citations I am relying on, and have consistently contradicted what the Treasury regulations say in plain English. (I would be happy if someone from the Department of Justice wants to try to show me where I may be in error.)

All of this no doubt sounds absurd to you. I expect you are unable to even consider the *possibility* that my conclusions could be correct. You may not wish to consider the possibility that the government you serve extorts and defrauds the citizenry far more than it "protects" them.

You of course are a busy man, and I suspect you will simply dismiss this as nonsense, without ever looking into it (and I admit that would be somewhat understandable, considering how "unconventional" my conclusions are). But this fraud must end, and your attention to it is paramount. At the moment I know of no better way to get your attention than by doing this:

By signing below, I hereby declare (under penalty of per-jury) that I have not filed any federal income tax return for the 1997 year or any subsequent year, nor have I paid any federal income taxes for those years. During those years, I received sufficient income that, if my income had been subject to the federal income tax, both payments and returns would have been required by law. If you believe my conclusions of law are in error, and my actions illegal, I hereby publicly and openly invite the Department of Justice to prosecute me.

I have posted my research, my attempts to get answers from the IRS, my experiences, and my case history at http://www.taxableincome.net for all the world to see (and I would be happy to post any rebuttal you can supply there as well). The truth will eventually come out, one way or the other. Which side you end up on depends upon your principles, your honesty, and your willingness to examine the evidence and face the truth.

I believe you have a moral and legal obligation, not only to immediately cease the baseless tax-related prosecutions of those U.S. citizens who are not actually subject to the federal income tax (i.e. most Americans), but also to initiate an investigation into the Department of the Treasury, and possibly some members of Congress, for ongoing attempts to intentionally deceive and defraud the people of the United States. What I actually *expect* you to do is another matter, but I hope you will demonstrate that your allegiance to political power does not outweigh your allegiance to your God, to your principles, to the law, to the truth, and to justice.

By signing below, I hereby declare under penalties of perjury that the above information is true and correct to the best of my knowledge.

Sincerely,
s/ Larken Rose
[address deleted for privacy]

cc: Charles O. Rossotti
Commissioner, Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Legal Basis for Not Filing / Not Paying

The following is a summary of a larger, 60-page report that is available for free from Mr. Rose's website at: http://www.taxableincome.net/docrequest.html. Be warned that because this article summarizes the 60-page report, the text is abbreviated, incomplete and hard to read. If the IRS isn't your issue, you might want to skip to the next article.

On the other hand, if income tax is important to you, this is a hot strategy and you should read this text as an introduction to what appears to be a very strong defence against the IRS.

Overview:

The regulatory definition of "gross income" is "income from whatever *source* derived, *unless excluded by law*"**[1]** (26 CFR § 1.61-1).

The general statutory definition of "gross income" is "income from whatever *source* derived"**[2]** (26 USC § 61).

The federal "income tax" is imposed upon individuals by 26 USC § 1, and is imposed upon "taxable income"**[3]**, which generally means "gross income" minus deductions (26 USC § 63, 26 CFR § 1.1-1(a)(1)).

Generally speaking, the requirement to *file* income tax returns is found in 26 USC § 6012, and depends upon the receipt of "gross income"**[4]** in excess of one's "exemption" amount.

[The, blue bracketed numbers above correspond to the "issues" addressed below.]

Issue #1, "Excluded Income":

In the general definition of "gross income" found in the regulations (26 CFR § 1.61-1), the term "unless excluded by law" is often misread to refer only to *statutory* exclusions. However, the predecessor regulations make clear that the phrase refers to exemption by statute, *or* by "fundamental law" (26 CFR § 39.21-1 (1956)), meaning the Constitution.

The prior regulations stated that in addition to the statutory exemptions, other income was "under the Constitution, *not taxable* by the Federal Government" (26 CFR § 39.22(b)-1 (1956)).

The older statutory definitions of "net income" (now "taxable income") and "gross income" used broad wording (26 USC §§ 21, 22(a) (1939)), and did not need to mention Constitutional limitations, since "every statute is to be read in the light of the constitution," and "[h]owever broad and general its language, it cannot be interpreted as extending beyond those matters which it was within the constitutional power of the legislature to reach" (*McCullough v. Com. Of Virginia*, 172 U.S. 102 (1898)).

Since regulations (when published in the Federal Register) are the official notice to the public of what the law requires of them (44 USC), the regulations must give specifics. For decades, the regulations defining "gross income" specifically stated that income of U.S. citizens derived from "foreign commerce" *must* be included in their "gross income," and also described income of foreigners, and income of those who receive most of their income from federal possessions (Regulations 62, Article 31 (1922), 26 CFR § 39.22(a)-1 (1956)).

The current regulations under 26 USC § 61 mention neither the Constitution, nor the types of commerce from which income "must be included" as "gross income". However, the regulations still show that some income is "excluded by law" (26 CFR § 1.61-1)—i.e., excluded by statute or by the Constitution, itself.

However, current income tax regulations specifically state that the "items" of income listed in 26 USC § 61 make up "classes of gross income" (26 CFR § 1.861-8(a)(3)). Further, such income is sometimes *excluded* "for federal income tax purposes" (26 CFR §§ 1.861-8(b)(1), 1.861-8T(d)(2)(ii)(A)).

The regulations then list what is *not* exempt (26 CFR § 1.861-8T(d)(2)(iii)), and give essentially the same list of types of commerce which were previously listed in the older regulations defining "gross income" (26 CFR § 39.22(a)-1 (1956)). These types of commerce are all related to *international* and *foreign* commerce (including commerce within federal possessions).

The general power to "lay and collect taxes" (U.S. Constitution, Article I, Section 8, Clause 1) *combined* with the power to "regulate commerce with foreign nations" (U.S Constitution, Article I, Section 8, Clause 3) undoubtedly gives Congress the power to impose an income tax on income derived from *foreign* commerce (*William E. Peck & Co. v. Lowe*, 247 U.S. 165 (1918)). However, mere receipt of income from *intrastate* commerce *cannot* be a proper subject of a federal excise tax. (Both the Supreme Court (*Stanton v. Baltic Mining* (240 U.S. 103)) and the Secretary of the Treasury (Treasury Decision 2303) agree that the income tax is in fact an "indirect" excise.)

Congress cannot gain jurisdiction over an event, or regulate an event not otherwise under federal jurisdiction (such as *intrastate* commerce), simply by exerting such control via taxation legislation. "To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress" (*Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922)), and such a law "cannot be sustained as an exercise of the taxing power of Congress conferred by section 8, article 1" (*Hill v. Wallace*, 259 U.S. 44 (1922)).

Mind you, this is *not* to say that the income tax is in any way invalid. These cases merely show *why* the income tax statutes and regulations *themselves* limit the tax to those engaged in *international* or *foreign* commerce.

Issue #2, "Sources of Income":

When income tax regulations implementing the Internal Revenue Code of 1954 were first published, they did not specifically mention the Constitutional restrictions on what constituted "gross income." Instead, the regulations began by stating that 26 USC § 861 and following (and the related regulations), "determine the *sources* of income for purposes of the income tax" (26 CFR § 1.861-1 (1958 to present)).

Under 26 USC § 61, the three major printings of the United States Code (USC, USCS, USCA) currently all contain editorially-supplied cross-references to 26 USC § 861 regarding "income from sources *within* the United States." This cross-reference is not currently part of the actual text of the law, but it was in 1939 (26 USC § 22(g) (1939)). However, the text of 26 USC § 861 identifies which income "shall be treated as income from sources *within* the United States."

It's not unusual for one section of the federal statutes to broadly describe a requirement, only to have other sections show that the general requirement applies only to those engaged in commerce under federal jurisdiction [e.g. the federal "anti-discrimination" laws at 23 USC §§ 623(a)(1), 630(b), 630(g)].

The federal income tax is no different. The early sections of the Internal Revenue Code generally describe a tax on income (26 USC §§ 1, 61, 63). But congress was well aware of its limited jurisdiction, and (in what is now Subchapter N, Chapter 1 of Title 26) Congress enumerated those situations in which "income from sources *within or without* the United States" was subject to the tax. All of the activities or types of commerce listed therein as subject to income tax concern those engaged in international or foreign commerce.

Although many assume that income from all types of commerce not listed (such as intrastate commerce) is also taxable, such assumptions are contrary to established law. When interpreting taxing statutes,

> "it is the established rule not to extend their provisions, *by implication*, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters *not specifically pointed out*." *Gould v. Gould*, 245 U.S. 151 (1917).

The regulations clearly state that 26 USC § 861 and following, and related regulations, "*determine* the *sources* of income for purposes of the income tax," and those sections *only* show income from certain *international* and *foreign* commerce to be included. It is in error to assume a greater scope to the law than what is "specifically pointed out."

Issue #3, "Taxable Income":

Section 861(b) of the Title 26 statutes is entitled "Taxable income from *sources* within United States," and the text thereof describes what "shall be included in full as taxable income from sources within the United States." There are numerous citations showing that 26 USC § 861(b), and the related regulations (beginning with 26 CFR § 1.861-8), are the sections to use to *determine* "taxable income from sources within the United States" (26 CFR §§ 1.861-1(a), 1.861-1(b), 1.861-8(a), 1.862-1(b), 1.863-1(c), etc.).

The current regulations (in addition to the historical statutes and regulations) make clear that only income from certain activities or types of commerce (i.e. "specific sources") is shown by 26 USC § 861(b) and 26 CFR § 1.861-8 to constitute "*taxable* income from sources within the United States" (26 CFR §§ 1.861-8(f)(3)(ii), 1.861-8(a), 1.861-8(f)(1), 26 CFR § 29.119-1 (1945), 29.119-9 (1945). 29.119-10 (1945)). This fact has been so obfuscated over the years that, today, 26 USC § 86 (read by itself out of context) seems to indicate that most domestic income is taxable.

However, the predecessor statutes make it abundantly clear that under that section, only the domestic income of those engaged in certain activities related to international or foreign commerce is taxable (Revenue Act of 1921, §§ 217, 232).

The activities enumerated by Congress in Subchapter N of the IRC, and the regulations promulgated by the Secretary of the Treasury under 26 USC § 861, match precisely the types of commerce which Issue #1 (above) shows to be constitutionally taxable by the federal government.

In sum, Part I (26 USC § 861 and following) give the general rules about the "source" and taxability of income from limited types of commerce. Part II and portions of Subchapter N enumerate those *types* of taxable commerce (e.g. 26 USC §§ 871, 882, 911, 936, etc.).

Issue #4, "Filing Requirement":

Both the statutes and regulations use the term "gross income" in two ways: in the generic sense, to mean *all* income; and in the "term of art" sense, to mean only that income which is *subject* to the federal income tax. The requirement to file an income tax return (26 USC § 6012) depends upon receipt of "gross income" in the latter sense, i.e. income *subject* to the tax.

In fact, the older regulations stated that income exempted by statute or "fundamental law" (Constitution) "should *not* be included in the return of income and need not be mentioned in the return" [Regulations 62, Article 71 (1922)]. Those regulations, consistent with what has been previously outlined, stated that citizens deriving income from *foreign* commerce "must" include such income in their "gross income."

The current 1040 instruction booklet and the current IRS Publication 525 ("Taxable and Nontaxable Income") each declare that U.S. citizens "must" report income they receive from "sources" *outside* the United States, but say nothing of the domestic-source income (within the United States) of citizens.

IRC Section 61 gives the general definition of "gross income from whatever source derived" for purposes of Title 26 (including 26 USC § 6012– "Persons Required to Make Returns of Income"). If some income is not specifically shown by law to constitute "income from sources *within* the United States" (26 USC § 861), or "income from sources *without* the United States" (26 USC § 862), then such income does not legally constitute "income from whatever *source* derived," and cannot create any filing requirement under 26 USC § 6012.

Mr. Rose seems to argue that *unless* the source of your income is specifically listed by law as "taxable," it's probably *not* taxable. Intense study of the Internal Revenue Code and relevant regulations and statutes concerning "sources" of income reportedly indicates that most of us derive our incomes from *sources* which are not truly taxable.

For more complete information, Mr. Rose has authored a 60+ page report entitled "Taxable Income," which offers a comprehensive explanation and proof of the Section 861 defense. You can download a free copy of his report at: **http://www.taxableincome.net/docrequest.html**

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

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"Who is John Galt?"

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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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:

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


Dear IRS,
I am writing to you to cancel my subscription.
Please remove my name from your mailing list.
6-19
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Schulz

Main Index > Cases and Codes > U. S. Constitution > Sixteenth Amendment

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.

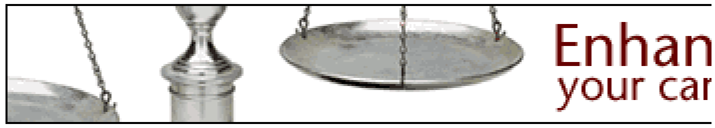
Annotations

'); } //

CITES BY TOPIC: situs

Black's Law Dictionary, Sixth Edition, page 1387:

> **Situs**. Lat. Situation; location; e.g. location or place of crime or business. Site; position; the place where a thing is considered, for example, with reference to jurisdiction over it, or the right or power to tax it. It imports fixedness of location. Situs of property, for tax purposes, is determined by whether the taxing state has sufficient contact with the personal property sought to be taxed to justify in in fairness the particular tax. Town of Cady v. Alexander Const. Co., 12 Wis.2d 236, 107 N.W.2d 267, 270.



Main Index : Cases and Codes : U.S. Constitution : Sixteenth Amendment

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

CITES BY TOPIC: source

Recall in our previous discussion that in the case of ***United States v. Burke*** (504 U.S. 229, 119 L Ed 2d 34, 112 S Ct. 1867), the Supreme Court ruled that "gross income" that was to be taxed had to come from a source. Why? Because otherwise the income tax laws would be so broad as to tax EVERYONE in the world! *Federal government income taxes are imposed on sources with specific geographical boundaries, and not the income itself, per United States v. Burke*. The income is just a way to compute the amount of tax but the tax itself is on a geographical and situational source. Clearly, there has to be some section of the Internal Revenue Code that ties the taxes we pay to some geographical boundary. This section deals with that subject.

There is often a lot of confusion in people's mind over the significance of the word "source" that we'd like to clear up before we go on. Therefore we'd like to refine the use of the term before continuing on with an explanation of specific "sources". Merriam Webster Dictionary of Law defines "source" as follows:

> ***source***
> ***1:*** *a point of origin*
> *Example: the* **source** *of the conflict*

There are actually two uses of the word "source" in the Internal Revenue Code. "Source" is used to describe a *TAX source* (a source for government revenue) in 26 U.S.C. Sec. 861, the 16th Amendment, and the IRS regulations (1.861) we discuss subsequently. Tax sources for the government are always tied to a geographical boundary and the occurrence of a specific event or situation. This is especially true of excise taxes, which occur on the happening of a specific *event*. For instance, there is a federal excise tax on gasoline. The event of buying gasoline by consumers within the geographical boundaries of the United States of America is an occasion for paying that particular federal excise tax. If the event occurs outside of the geographical boundaries of the U.S.A. or doesn't involve the buying of gasoline, then the tax can't be imposed.

"Source" is also used to describe an *INCOME source* for individuals or "persons" (and not necessarily the government) in Chapter 24 of the I.R.C, which is entitled "CHAPTER 24 - COLLECTION OF INCOME TAX AT ***SOURCE*** ON WAGES " and section 3402 of the I.R.C. These sections deal with *withholding*, but the withholding is occurring on the *citizen's income source*, which then becomes the government's revenue/tax *source* upon receipt by the government. In this case, the withholding on wages occurs as an imputed "excise tax" based on the "event" of a citizen receiving income from their employer within the geographical boundaries of the United States of America. Note, however, that excise taxes that are Constitutional always occur on *business transactions and businesses*. Excise taxes are referred to in the Constitution as ***indirect taxes***, as we learned in our discussion of the Supreme Court case of ***Pacific Ins. Co. v. Soule***, 74 U. S. 433, 1868 in section 6.4.2 and they always fall on *consumers* of the product made by the business. Valid federal excise taxes CANNOT fall on natural persons or citizens because then they become ***direct taxes.*** Direct taxes on citizens violate Article 1, Section 9, Clause 4 of the Constitution, which states "No Capitiation or other direct tax shall be laid unless in proportion to the Census or Enumeration herein before directed to be taken." In this case, the income taxes on wages are deducted and paid by the employer (the business) with the consent or permission of the employee (W-4), but in actuality they also REDUCE the income of the recipient and the taxes must be accounted for and a return prepared by the citizen/recipient, not the business, which makes them into a direct tax that is clearly unconstitutional. It is very important to understand this distinction. A good way to think about this is if a tax reduces the income of a citizen from what they otherwise would have received and if it is involuntary and not discretionary, then it's a *direct tax*. This issue was settled in the Supreme Court Case of ***Pollack v. Farmer's Loan and Trust Company,*** 157 U.S. 429 and 158 U.S. 601, 1883.

With that out of the way, we'll spend the remainder of this section talking about government "sources" of income, so let's review: the "income tax" is imposed on "*taxable income*," which means "*gross income*" minus deductions.

"*Gross income*" is defined in 26 USC § 61 as "*all income from whatever* ***source*** *derived*." The phrase "*from whatever* ***source*** *derived*" may initially appear all-encompassing, but for the specifics about "*income from* ***sources***," the reader of the law is repeatedly referred to Section **861** and following (of the statutes) and the related regulations. For example, in the full version of Title 26 (with all notes and amendments) which appears on Congress' own web site, Section 61 *itself* has the following cross-reference:

> *"**Income from sources** -*
> ***Within*** *the United States, see* ***section 861*** *of this title.*
> *Without the United States, see section 862 of this title."*

So the section which generally defines "gross income" specifically refers to 26 USC § 861 regarding income from "sources" within the United States** (the federal zone). A similar reference is also found in the indexes of the United States Code, which (although they vary somewhat in the exact wording) have entries such as:

> *"Income tax*
> ***Sources*** *of income*
> ***Determination****, 26 §* ***861*** *et seq.*
> ***Within*** *the U.S., 26 §* ***861****"*

Again, income from "sources" within the United States** (the federal zone) is specifically dealt with by Section 861, and "*determination*" of sources of income is also dealt with by Section 861 and the following sections. In addition, Sections 79, 105, 410, 414 and 505 each identify Section **861** as the section which determines what constitutes "*income from* ***sources*** *within the United States*," and Section 306 even uses the phrase "*part I of subchapter N (sec.* ***861*** *and following, relating to* ***determination of sources of income****)*."

As shown, 26 USC § 861 and following (which make up Part I of Subchapter N of the Code) are very relevant to determining what is considered a "source of income," and Section 861 in particular deals with income from "sources" ***within*** the United States** (the federal zone). Not surprisingly, Section 861 is entitled "*Income from* ***sources*** *within the United States*," and the first two subsections of Section 861 are entitled "***Gross income*** *from sources within the United States*" and "***Taxable income*** *from sources within the United States*." Section 861 is also the first section of Subchapter N of the Code, which is entitled "*Tax based on* ***income from sources*** *within or without the United States*." Clearly this is relevant to a tax on "***income*** *from whatever* ***source*** *derived*."

As mentioned before, the *statutes* passed by Congress are interpreted and implemented by *regulations* published in the Code of Federal Regulations ("CFR") by the Secretary of the Treasury. The Index of the CFR, under "*Income taxes*," has an entry that reads "*Income from* ***sources*** *inside or outside U.S.,* ***determination of sources of income****, 26 CFR 1 (****1.861-1****--1.864-8T)*." This is the *only* entry in the Index relating to income from sources *within* the United States** (the federal zone), and the regulations listed (26 CFR § 1.861-1 and following) correspond to Section 861 of the *statutes*. (The "*26*" refers to Title 26, the "*1*" after "*CFR*" refers to Part 1 of the regulations ("Income Taxes"), and the "*.861*" refers to Section 861 of the statutes.) These regulations fall under the heading "***Determination of sources of income***." The following is how these regulations begin:

> *"Sec. 1.861-1 Income from sources within the United States.*
> *(a) Categories of income. Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax." [26 CFR § 1.861-1]*

The meaning of this is unmistakable. The "income tax" is imposed on "*income from whatever* ***source*** *derived*," and Section 861 and following, and the related regulations, determine what is considered a "***source***" of income "*for purposes of* *the income tax*." The first sentence of the regulations under 26 USC § 861 has stated this since 1954, when Section 861 first came into existence. Note that these define "***the***" sources of income subject to the tax, meaning ***there are no others***. Therefore, the meaning of "*income from whatever **source** derived*" (the definition of "*gross income*" in Section 61) ***is*** limited by Section 861 (and following sections) and the related regulations. The meaning of the phrase "***whatever** source*" depends completely on the meaning of the word "***source***." The word "*whatever*" does not expand the meaning of "*source*" any more than the phrase "***all** firearms*" (in the example above) expands the legal meaning of the word "*firearm*."

The above section of regulations also refutes the common but incorrect position that the "*items*" of income listed in Section 61 are "*sources*," since Section 61 is obviously **not** the section which determines the "*sources*" of income for purposes of the income tax.

(There is a chart at the end of this report showing the outline of Part I of Subchapter N and related regulations, and showing many of the citations used in this report.)

While the significance of Section 861 and the related regulations may be obvious, the point needs to be thoroughly proven, since most tax professionals concede that Section 861 and its regulations are ***not*** about the income of United States citizens living and working exclusively within the 50 states of the United States. (Below it will be shown ***why*** it is so significant that "*section 861 and following... and the regulations thereunder, determine the sources of income for purposes of the income tax*."). The IRS's own publications clarify the issue of "source" for us. In IRS Publication 54 (for the year 2000, on page 4), we read the following:

> Source of Earned Income
>
> *The source of your earned income is the place where you perform the services for which you received the income. Foreign earned income is income you receive for performing personal services in a foreign country. Where or how you are paid has no effect on the source of the income. For example, income you receive for work done in France is income from a foreign source even if the income is paid directly to your bank ac-count in the United States and your employer is located in New York City.*
>
> *If you receive a specific amount for work done in the United States, you must report that amount as U.S. source income. If you cannot determine how much is for work done in the United States, or for work done partly in the United States and partly in a foreign country, determine the amount of U.S. source income using the method that most correctly shows the proper source of your income.*
>
> *In most cases you can make this determination on a time basis. U.S. source income is the amount that results from multiplying your total pay (including allowances, re-imbursements other than for foreign moves, and noncash fringe benefits) by a fraction. The numerator (top number) is the number of days you worked within the United States. The denominator is the total number of days of work for which you were paid.*

IMPORTANT NOTE: *All uses of the term "United States" in the context of natural persons actually mean the "federal zone" and not the 50 states of the United States. This is in complete agreement with the definition of the terms "United States" and "State" found in 26 U.S.C. section 7700. It is also consistent with Article 1, Section 9, Clause 4 and Article 1, Section 2, Clause 3 of the U.S. Constitution, which forbid direct taxes on natural persons without using apportionment.*

This is also suggested by the title of Part I of Subchapter N (of which 861 is the first section), "*Source rules and other general rules relating to **foreign** income*." Under the usual overly-broad (and incorrect) interpretation of the legal scope of the term "*gross income*," this would appear as a contradiction, since "*Income from sources **within** the United States*" (the title of Section 861) would at first glance seem to be the opposite of "***foreign*** *income*." The specific taxable sources shown later demonstrate that income from *within* the United States** (the federal zone) can be taxable only if received by certain individuals ***outside*** of the United States** (the federal zone), thus making the income ***foreign*** income. For the purposes of the income tax, as we discussed in section 5.3, income earned from within the 50 states is counted as "foreign income".

While the title of a part of the statutes may indicate what that part is about, it should be mentioned that 26 USC § 7806(b) states that such titles do not change the actual meaning of the law ("*nor shall any… descriptive matter relating to the contents of this title be given any legal effect*"). The above explanation for the title of Part I, Subchapter N is therefore not crucial, but does give a possible explanation of why the title is as it is.

(Question for Doubters: *Does Part I (Section 861 and following) of Subchapter N, and related regulations, determine what is considered a "source" of income for purposes of the federal income tax?*)

§ 861. Income from sources within the United States

How Current is This?

(a) Gross income from sources within United States

The following items of gross income shall be treated as income from sources within the United States:

(1) Interest

Interest from the United States or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations not including—

(A) interest from a resident alien individual or domestic corporation, if such individual or corporation meets the 80-percent foreign business requirements of subsection (c)(1),

(B) interest—

(i) on deposits with a foreign branch of a domestic corporation or a domestic partnership if such branch is engaged in the commercial banking business, and

(ii) on amounts satisfying the requirements of subparagraph (B) of section 871 (i)(3) which are paid by a foreign branch of a domestic corporation or a domestic partnership, and

(C) in the case of a foreign partnership, which is predominantly engaged in the active conduct of a trade or business outside the United States, any interest not paid by a trade or business engaged in by the partnership in the United States and not allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(2) Dividends

The amount received as dividends—

(A) from a domestic corporation other than a corporation which has an election in effect under section 936, or

(B) from a foreign corporation unless less than 25 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was effectively connected (or treated as effectively connected other than income described in section 884 (d)(2)) with the conduct of a trade or business within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period which was effectively connected (or treated as effectively connected other than income described in section 884 (d)(2)) with the conduct of a trade or business within the United States bears to its gross income from all sources; but dividends (other than dividends for which a deduction is allowable under section 245 (b)) from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent (and only to the extent) exceeding the amount which is 100/70th of the amount of the deduction allowable under section 245 in respect of such dividends, or

(C) from a foreign corporation to the extent that such amount is required by section 243 (e) (relating to certain dividends from foreign corporations) to be treated as dividends from a domestic corporation which is subject to taxation under this chapter, and to such extent subparagraph (B) shall not apply to such amount, or

(D) from a DISC or former DISC (as defined in section 992 (a)) except to the extent attributable (as determined under regulations prescribed by the Secretary) to qualified export receipts described in section 993 (a)(1) (other than interest and gains described in section 995 (b)(1)).

In the case of any dividend from a 20-percent owned corporation (as defined in section 243 (c)(2)), subparagraph (B) shall be applied by substituting "100/80th" for "100/70th".

(3) Personal services

Compensation for labor or personal services performed in the United States; except that compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if—

(A) the labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,

(B) such compensation does not exceed $3,000 in the aggregate, and

(C) the compensation is for labor or services performed as an employee of or under a contract with—

(i) a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

In addition, compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if the labor or services are performed by a nonresident alien individual in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States.

(4) Rentals and royalties

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

(5) Disposition of United States real property interest

Gains, profits, and income from the disposition of a United States real property interest (as defined in section 897 (c)).

(6) Sale or exchange of inventory property

Gains, profits, and income derived from the purchase of inventory property (within the meaning of section 865 (i)(1)) without the United States (other than within a possession of the United States) and its sale or exchange within the United States.

(7) Amounts received as underwriting income (as defined in section 832 (b)(3)) derived from the issuing (or reinsuring) of any insurance or annuity contract—

(A) in connection with property in, liability arising out of an activity in, or in connection with the lives or health of residents of, the United States, or

(B) in connection with risks not described in subparagraph (A) as a result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect to issuing (or reinsuring) any insurance or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of, the United States.

(8) Social security benefits

Any social security benefit (as defined in section 86 (d)).

(b) Taxable income from sources within United States

From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

(c) Foreign business requirements

(1) Foreign business requirements

(A) In general

An individual or corporation meets the 80-percent foreign business requirements of this paragraph if it is shown to the satisfaction of the Secretary that at least 80 percent of the gross income from all sources of such individual or corporation for the testing period is active foreign business income.

(B) Active foreign business income

For purposes of subparagraph (A), the term "active foreign business income" means gross income which—

(i) is derived from sources outside the United States (as determined under this subchapter) or, in the case of a corporation, is attributable to income so derived by a subsidiary of such corporation, and

(ii) is attributable to the active conduct of a trade or business in a foreign country or possession of the United States by the individual or corporation (or by a subsidiary.)

For purposes of this subparagraph, the term "subsidiary" means any corporation in which the corporation referred to in this subparagraph owns (directly or indirectly) stock meeting the requirements of section 1504 (a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears).

(C) Testing period

For purposes of this subsection, the term "testing period" means the 3-year period ending with the close of the taxable year of the individual or corporation preceding the payment (or such part of such period as may be applicable). If the individual or corporation has no gross income for such 3-year period (or part thereof), the testing period shall be the taxable year in which the payment is made.

(2) Look-thru where related person receives interest

(A) In general

In the case of interest received by a related person from a resident alien individual or domestic corporation meeting the 80-percent foreign business requirements of paragraph (1), subsection (a)(1)(A) shall apply only to a percentage of such interest equal to the percentage which—

(i) the gross income of such individual or corporation for the testing period from sources outside the United States (as determined under this subchapter), is of

(ii) the total gross income of such individual or corporation for the testing period.

(B) Related person

For purposes of this paragraph, the term "related person" has the meaning given such term by section 954 (d)(3), except that—

(i) such section shall be applied by substituting "the individual or corporation making the payment" for "controlled foreign corporation" each place it appears, and

(ii) such section shall be applied by substituting "10 percent or more" for "more than 50 percent" each place it appears.

(d) Special rule for application of subsection (a)(2)(B)

For purposes of subsection (a)(2)(B), if the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified, the requirements of such subsection shall be applied with respect to the taxable year of such corporation in which the payment of the dividend is made.

(e) Income from certain railroad rolling stock treated as income from sources within the United States

(1) General rule

For purposes of subsection (a) and section 862 (a), if—

(A) a taxpayer leases railroad rolling stock which is section 1245 property (as defined in section 1245 (a)(3)) to a domestic common carrier by railroad or a corporation which is controlled, directly or indirectly, by one or more such common carriers, and

(B) the use under such lease is expected to be use within the United States,

all amounts includible in gross income by the taxpayer with respect to such railroad rolling stock (including gain from sale or other disposition of such railroad rolling stock) shall be treated as income from sources within the United States. The requirements of subparagraph (B) of the preceding sentence shall be treated as satisfied if the only expected use outside the United States is use by a person (whether or not a United States person) in Canada or Mexico on a temporary basis which is not expected to exceed a total of 90 days in any taxable year.

(2) Paragraph (1) not to apply where lessor is a member of controlled group which includes a railroad

Paragraph (1) shall not apply to a lease between two members of the same controlled group of corporations (as defined in section 1563) if any member of such group is a domestic common carrier by railroad or a switching or terminal company all of whose stock is owned by one or more domestic common carriers by railroad.

(3) Denial of foreign tax credit

No credit shall be allowed under section 901 for any payments to foreign countries with respect to any amount received by the taxpayer with respect to railroad rolling stock which is subject to paragraph (1).

(f) Cross reference

For treatment of interest paid by the branch of a foreign corporation, see section 884 (f).

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§ 862. Income from sources without the United States

How Current is This?

(a) Gross income from sources without United States

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

(1) interest other than that derived from sources within the United States as provided in section 861 (a)(1);

(2) dividends other than those derived from sources within the United States as provided in section 861 (a)(2);

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

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

(5) gains, profits, and income from the sale or exchange of real property located without the United States;

(6) gains, profits, and income derived from the purchase of inventory property (within the meaning of section 865 (i)(1)) within the United States and its sale or exchange without the United States;

(7) underwriting income other than that derived from sources within the United States as provided in section 861 (a)(7); and

(8) gains, profits, and income from the disposition of a United States real property interest (as defined in section 897 (c)) when the real property is located in the Virgin Islands.

(b) Taxable income from sources without United States

From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

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Sec. 861. - Income from sources within the United States

(a) Gross income from sources within United States

The following items of gross income shall be treated as income from sources within the United States:

(1) Interest

Interest from the United States or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations not including -

(A)

interest from a resident alien individual or domestic corporation, if such individual or corporation meets the 80-percent foreign business requirements of subsection (c)(1), and

(B)

interest -

(i)

on deposits with a foreign branch of a domestic corporation or a domestic partnership if such branch is engaged in the commercial banking business, and

(ii)

on amounts satisfying the requirements of subparagraph (B) of section 871(i)(3) which are paid by a foreign branch of a domestic corporation or a domestic partnership.

(2) Dividends

The amount received as dividends -

(A)

from a domestic corporation other than a corporation which has an election in effect under section 936, or

(B)

from a foreign corporation unless less than 25 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was effectively connected (or treated as effectively connected other than income described in section 884(d)(2)) with the conduct of a trade or business within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period which was effectively connected (or treated as effectively connected other than income described in section 884(d)(2)) with the conduct of a trade or business within the United States bears to its gross income from all sources; but dividends (other than dividends for which a deduction is allowable under section 245(b)) from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent (and only to the extent) exceeding the amount which is 100/70th of the amount of the deduction allowable under section 245 in respect of such dividends, or

(C)

from a foreign corporation to the extent that such amount is required by section 243(e) (relating to certain dividends from foreign corporations) to be treated as dividends from a domestic corporation which is subject to taxation under this chapter, and to such extent subparagraph (B) shall not apply to such amount, or

(D)

from a DISC or former DISC (as defined in section 992(a)) except to the extent attributable (as determined under regulations prescribed by the Secretary) to qualified export receipts described in section 993(a)(1) (other than interest and gains described in section 995(b)(1)).

In the case of any dividend from a 20-percent owned corporation (as defined in section 243(c)(2)), subparagraph (B) shall be applied by substituting ''100/80th'' for ''100/70th''.

(3) Personal services

Compensation for labor or personal services performed in the United States; except that compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if -

(A)

the labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,

(B)

such compensation does not exceed $3,000 in the aggregate, and

(C)

the compensation is for labor or services performed as an employee of or under a contract with -

(i)

a nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii)

an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

In addition, except for purposes of sections 79 and 105 and subchapter D, compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if the labor or services are performed by a nonresident alien individual in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States.

(4) Rentals and royalties

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

(5) Disposition of United States real property interest

Gains, profits, and income from the disposition of a United States real property interest (as defined in section 897(c)).

(6) Sale or exchange of inventory property

Gains, profits, and income derived from the purchase of inventory property (within the meaning of section 865 (i)(1)) without the United States (other than within a possession of the United States) and its sale or exchange within the United States.

(7)

Amounts received as underwriting income (as defined in section 832(b)(3)) derived from the issuing (or reinsuring) of any insurance or annuity contract -

(A)

in connection with property in, liability arising out of an activity in, or in connection with the lives or health of residents of, the United States, or

(B)

in connection with risks not described in subparagraph (A) as a result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect to issuing (or reinsuring) any insurance or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of, the United States.

(8) Social security benefits

Any social security benefit (as defined in section 86 (d)).

(b) Taxable income from sources within United States

From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

(c) Foreign business requirements

(1) Foreign business requirements

(A) In general

An individual or corporation meets the 80-percent foreign business requirements of this paragraph if it is shown to the satisfaction of the Secretary that at least 80 percent of the gross income from all sources of such individual or corporation for the testing period is active foreign business income.

(B) Active foreign business income

For purposes of subparagraph (A), the term ''active foreign business income'' means gross income which -

(i)

is derived from sources outside the United States (as determined under this subchapter) or, in the case of a corporation, is attributable to income so derived by a subsidiary of such corporation, and

(ii)

is attributable to the active conduct of a trade or business in a foreign country or possession of the United

States by the individual or corporation (or by a subsidiary.) For purposes of this subparagraph, the term ''subsidiary'' means any corporation in which the corporation referred to in this subparagraph owns (directly or indirectly) stock meeting the requirements of section 1504(a)(2) (determined by substituting ''50 percent'' for ''80 percent'' each place it appears).

(C) Testing period

For purposes of this subsection, the term ''testing period'' means the 3-year period ending with the close of the taxable year of the individual or corporation preceding the payment (or such part of such period as may be applicable). If the individual or corporation has no gross income for such 3-year period (or part thereof), the testing period shall be the taxable year in which the payment is made.

(2) Look-thru where related person receives interest

(A) In general

In the case of interest received by a related person from a resident alien individual or domestic corporation meeting the 80-percent foreign business requirements of paragraph (1), subsection (a)(1)(A) shall apply only to a percentage of such interest equal to the percentage which -

(i)

the gross income of such individual or corporation for the testing period from sources outside the United States (as determined under this subchapter), is of

(ii)

the total gross income of such individual or corporation for the testing period.

(B) Related person

For purposes of this paragraph, the term ''related person'' has the meaning given such term by section 954(d)(3), except that -

(i)

such section shall be applied by substituting ''the individual or corporation making the payment'' for ''controlled foreign corporation'' each place it appears, and

(ii)

such section shall be applied by substituting ''10 percent or more'' for ''more than 50 percent'' each place it appears.

(d) Special rule for application of subsection (a)(2)(B)

For purposes of subsection (a)(2)(B), if the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified, the requirements of such subsection shall be applied with respect to the taxable year of such corporation in which the payment of the dividend is made.

(e) Income from certain railroad rolling stock treated as income from sources within the United States

(1) General rule

For purposes of subsection (a) and section 862(a), if -

(A)

a taxpayer leases railroad rolling stock which is section 1245 property (as defined in section 1245(a)(3)) to a domestic common carrier by railroad or a corporation which is controlled, directly or indirectly, by one or more such common carriers, and

(B)

the use under such lease is expected to be use within the

United States,

all amounts includible in gross income by the taxpayer with respect to such railroad rolling stock (including gain from sale or other disposition of such railroad rolling stock) shall be treated as income from sources within the United States. The requirements of subparagraph (B) of the preceding sentence shall be treated as satisfied if the only expected use outside the United States is use by a person (whether or not a United States person) in Canada or Mexico on a temporary basis which is not expected to exceed a total of 90 days in any taxable year.

(2) Paragraph (1) not to apply where lessor is a member of controlled group which includes a railroad

Paragraph (1) shall not apply to a lease between two members of the same controlled group of corporations (as defined in section 1563) if any member of such group is a domestic common carrier by railroad or a switching or terminal company all of whose stock is owned by one or more domestic common carriers by railroad.

(3) Denial of foreign tax credit

No credit shall be allowed under section 901 for any payments to foreign countries with respect to any amount received by the taxpayer with respect to railroad rolling stock which is subject to paragraph (1).

(f)

Cross reference

For treatment of interest paid by the branch of a foreign corporation, see section 884(f)

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Sec. 862. - Income from sources without the United States

(a) Gross income from sources without United States

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

(1)

interest other than that derived from sources within the United States as provided in section 861(a)(1);

(2)

dividends other than those derived from sources within the United States as provided in section 861(a)(2);

(3)

compensation for labor or personal services performed without the United States;

(4)

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

(5)

gains, profits, and income from the sale or exchange of real property located without the United States;

(6)

gains, profits, and income derived from the purchase of inventory property (within the meaning of section 865(i)(1)) within the United States and its sale or exchange without the United States;

(7)

underwriting income other than that derived from sources within the United States as provided in section 861(a)(7); and

(8)

gains, profits, and income from the disposition of a United States real property interest (as defined in section 897(c)) when the real property is located in the Virgin Islands.

(b) Taxable income from sources without United States

From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income

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CITES BY TOPIC: gross income

"income" defined-NOTE: It must FIRST be "income" in order to be "gross income"!

Commissioner v. Duberstein, 363 U.S. 278 (1960):

> "***The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute 4 passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since.*** The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. 5 Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See Lockard v. Commissioner, 166 F.2d 409. The meaning of the statutory term has been shaped largely by the decisional law."

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26 U.S.C.A. 954 (1928): Gross Income (2.28 Mbytes)

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26 U.S.C.A. 22 (1935): Gross Income (5.17 Mbytes)

TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter N > PART II > Subpart A > Sec. 872.

Sec. 872. - Gross income

> (a) General rule
>
> In the case of a nonresident alien individual, except where the context clearly indicates otherwise, gross income includes only -
>
> (1) gross income which is derived from sources **within** the United States [** the federal zone] and which is not effectively connected with the conduct of a trade or business within the United States [** federal zone], and
>
> (2) gross income which is effectively connected with the conduct of a trade or business within the United States [** federal zone].

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26 CFR Sec. 31.3402(p)-1

> 26 CFR Sec. 31.3402(p)-1
> Title 26
> CHAPTER I

SUBCHAPTER C
PART 31
Subpart E

Sec. 31.3402(p)-1 Voluntary withholding agreements.

(a) In general. An employee and his employer may enter into an agreement under section 3402(b) to provide for the withholding of income tax upon payments of amounts described in paragraph (b)(1) of Sec. 31.3401(a)-3, made after December 31, 1970. **An agreement may be entered into under this section only with respect to amounts which are includible in the gross income of the employee under section 61, and must be applicable to all such amounts paid by the employer to the employee.** The amount to be withheld pursuant to an agreement under section 3402(p) shall be determined under the rules contained in section 3402 and the regulations thereunder. (b) Form and duration of agreement. (1)(i) Except as provided in subdivision (ii) of this subparagraph, an employee who desires to enter into an agreement under section 3402(p) shall furnish his employer with Form W-4 (withholding exemption certificate) executed in accordance with the provisions of section 3402(f) and the regulations thereunder. The furnishing of such Form W-4 shall constitute a request for withholding.

(ii) In the case of an employee who desires to enter into an agreement under section 3402(p) with his employer, if the employee performs services (in addition to those to be the subject of the agreement) the remuneration for which is subject to mandatory income tax withholding by such employer, or if the employee wishes to specify that the agreement terminate on a specific date, the employee shall furnish the employer with a request for withholding which shall be signed by the employee, and shall contain -

(a) The name, address, and social security number of the employee making the request,
(b) The name and address of the employer,
(c) A statement that the employee desires withholding of Federal income tax, and applicable, of qualified State individual income tax (see paragraph (d)(3)(i) of Sec. 301.6361-1 of this chapter (Regulations on Procedures and Administration)), and
(d) If the employee desires that the agreement terminate on a specific date, the date of termination of the agreement. If accepted by the employer as provided in subdivision (iii) of this subparagraph, the request shall be attached to, and constitute part of, the employee's Form W-4. An employee who furnishes his employer a request for withholding under this subdivision shall also furnish such employer with Form W-4 if such employee does not already have a Form W-4 in effect with such employer.

(iii) No request for withholding under section 3402(p) shall be effective as an agreement between an employer and an employee until the employer accepts the request by commencing to withhold from the amounts with respect to which the request was made.

{2) An agreement under section 3402 (p) shall be effective for such period as the employer and employee mutually agree upon. However, either the employer or the employee may terminate the agreement prior to the end of such period by furnishing a signed written notice to the other. Unless the employer and employee agree to an earlier termination date, the notice shall be effective with respect to the first payment of an amount in respect of which the agreement is in effect which is made on or after the first 'status determination date' (January 1, May 1, July 1, and October 1 of each year) that occurs at least 30 days after the date on which the notice is furnished. If the employee executes a new Form W-4, the request upon which an agreement under section 3402 (p) is based shall be attached to, and constitute a part of, such new Form W-4.

(86 Stat. 944, 26 U.S.C. 6364; 68A Stat. 917, 26 U.S.C. 7805) (T.D. 7096, 36 FR 5216, Mar. 18, 1971, as amended by T.D. 7577, 43 FR 59359, Dec. 20, 1978)

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TITLE 26

TITLE 26—INTERNAL REVENUE CODE

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

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PART I—SOURCE RULES AND OTHER GENERAL RULES RELATING TO FOREIGN INCOME

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§ 863. Special rules for determining source

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(a) Allocation under regulations

Items of gross income, expenses, losses, and deductions, other than those specified in sections 861 (a) and 862 (a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

(b) Income partly from within and partly from without the United States

In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary. Gains, profits, and income—

(1) from services rendered partly within and partly without the United States,

(2) from the sale or exchange of inventory property (within the meaning of section 865 (i)(1)) produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States, or

(3) derived from the purchase of inventory property (within the meaning of section 865 (i)(1)) within a possession of the United States and its sale or exchange within the United States,

shall be treated as derived partly from sources within and partly from sources without the United States.

(c) Source rule for certain transportation income

(1) Transportation beginning and ending in the United States

All transportation income attributable to transportation which begins and ends in the United States shall be treated as derived from sources within the United States.

(2) Other transportation having United States connection

(A) In general

50 percent of all transportation income attributable to transportation which—

(i) is not described in paragraph (1), and

(ii) begins or ends in the United States,

shall be treated as from sources in the United States.

(B) Special rule for personal service income

Subparagraph (A) shall not apply to any transportation income which is income derived from personal services performed by the taxpayer, unless such income is attributable to transportation which—

(i) begins in the United States and ends in a possession of the United States, or

(ii) begins in a possession of the United States and ends in the United States.

In the case of transportation income derived from, or in connection with, a vessel, this subparagraph shall only apply if the taxpayer is a citizen or resident alien.

(3) Transportation income

For purposes of this subsection, the term "transportation income" means any income derived from, or in connection with—

(A) the use (or hiring or leasing for use) of a vessel or aircraft, or

(B) the performance of services directly related to the use of a vessel or aircraft.

For purposes of the preceding sentence, the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

(d) Source rules for space and certain ocean activities

(1) In general

Except as provided in regulations, any income derived from a space or ocean activity—

(A) if derived by a United States person, shall be sourced in the United States, and

(B) if derived by a person other than a United States person, shall be sourced outside the United States.

(2) Space or ocean activity

For purposes of paragraph (1)—

(A) In general

The term "space or ocean activity" means—

(i) any activity conducted in space, and

(ii) any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States.

Such term includes any activity conducted in Antarctica.

(B) Exception for certain activities

The term "space or ocean activity" shall not include—

(i) any activity giving rise to transportation income (as defined in section 863 (c)),

(ii) any activity giving rise to international communications income (as defined in subsection (e)(2)), and

(iii) any activity with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States (as defined in section 638).

For purposes of applying section 638, the jurisdiction of any foreign country shall not include any jurisdiction not recognized by the United States.

(e) International communications income

(1) Source rules

(A) United States persons

In the case of any United States person, 50 percent of any international communications income shall be sourced in the United States and 50 percent of such income shall be sourced outside the United States.

(B) Foreign persons

(i) In general Except as provided in regulations or clause (ii), in the case of any person other than a United States person, any international communications income shall be sourced outside the United States.

(ii) Special rule for income attributable to office or fixed place of business in the United States In the case of any person (other than a United States person) who maintains an office or other fixed place of business in the United States, any international communications income attributable to such office or other fixed place of business shall be sourced in the United States.

(2) Definition

For purposes of this section, the term "international communications income" includes all income derived from the transmission of communications or data from the United States to any foreign country (or possession of the United States) or from any foreign country (or possession of the United States) to the United States.

Code

Sec. 1.61-1 Gross income.

(a) General definition.

Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, Sec. 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

(b) Cross references.

Cross references to other provisions of the Code are to be found throughout the regulations under section 61. The purpose of these cross references is to direct attention to the more common items which are included in or excluded from gross income entirely, or treated in some special manner. To the extent that another section of the Code or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and the regulations thereunder. The cross references do not cover all possible items.

(1) For examples of items specifically included in gross income, see Part II (section 71 and following), Subchapter B, Chapter 1 of the Code.

(2) For examples of items specifically excluded from gross income, see part III (section 101 and following), Subchapter B, Chapter 1 of the Code.

(3) For general rules as to the taxable year for which an item is to be included in gross income, see section 451 and the regulations thereunder.

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The Federalist Papers : No. 78

The Judiciary Department
From McLEAN'S Edition, New York.

HAMILTON

To the People of the State of New York:

WE PROCEED now to an examination of the judiciary department of the proposed government.

In unfolding the defects of the existing Confederation, the utility and necessity of a federal judicature have been clearly pointed out. It is the less necessary to recapitulate the considerations there urged, as the propriety of the institution in the abstract is not disputed; the only questions which have been raised being relative to the manner of constituting it, and to its extent. To these points, therefore, our observations shall be confined.

The manner of constituting it seems to embrace these several objects: 1st. The mode of appointing the judges. 2d. The tenure by which they are to hold their places. 3d. The partition of the judiciary authority between different courts, and their relations to each other.

First. As to the mode of appointing the judges; this is the same with that of appointing the officers of the Union in general, and has been so fully discussed in the two last numbers, that nothing can be said here which would not be useless repetition.

Second. As to the tenure by which the judges are to hold their places; this chiefly concerns their duration in office; the provisions for their support; the precautions for their responsibility.

According to the plan of the convention, all judges who may be appointed by the United States are to hold their offices DURING GOOD BEHAVIOR; which is conformable to the most approved of the State constitutions and among the rest, to that of this State. Its propriety having been drawn into question by the adversaries of that plan, is no light symptom of the rage for objection, which disorders their imaginations and judgments. The standard of good behavior for the continuance in office of the judicial magistracy, is certainly one of the most valuable of the modern improvements in the practice of government. In a monarchy it is an excellent barrier to the despotism of the prince; in a republic it is a no less excellent barrier to the encroachments and oppressions of the representative body. And it is the best expedient which can be devised in any government, to secure a steady, upright, and impartial administration of the laws.

Whoever attentively considers the different departments of power must perceive, that, in a government in which they are separated from each other, the judiciary, from the nature of its functions, will always be the least dangerous to the political rights of the Constitution; because it will be least in a capacity to annoy or injure them. The Executive not only dispenses the honors, but holds the sword of the community. The legislature not only commands the purse, but prescribes the rules by which the duties and rights of every citizen are to be regulated. The judiciary, on the contrary, has no influence over either the sword or the purse; no direction either of the strength or of the wealth of the society; and can take no active resolution whatever. It may truly be said to have neither FORCE nor WILL, but merely judgment; and must ultimately depend upon the aid of the executive arm even for the efficacy of its judgments.

This simple view of the matter suggests several important consequences. It proves incontestably, that the judiciary is beyond comparison the weakest of the three departments of power**1**; that it can never attack with success either of the other two; and that all possible care is requisite to enable it to defend itself against their attacks. It equally proves, that though individual oppression may now and then proceed from the courts of justice, the general liberty of the people can never be endangered from that quarter; I mean so long as the judiciary remains truly distinct from both the legislature and the Executive. For I agree, that "there is no liberty, if the power of judging be not separated from the legislative and executive powers."**2** And it proves, in the last place, that as liberty can have nothing to fear from the judiciary alone, but would have every thing to fear from its union with either of the other departments; that as all the effects of such a union must ensue from a dependence of the former on the latter, notwithstanding a nominal and apparent separation; that as, from the natural feebleness of the judiciary, it is in continual jeopardy of being overpowered, awed, or influenced by its co-ordinate branches; and that as nothing can contribute so much to its firmness and independence as permanency in office, this quality may therefore be justly regarded as an indispensable ingredient in its constitution, and, in a great measure, as the citadel of the public justice and the public security.

The complete independence of the courts of justice is peculiarly essential in a limited Constitution. By a limited Constitution, I understand one which contains certain specified exceptions to the legislative authority; such, for instance, as that it shall pass no bills of attainder, no ex-post-facto laws, and the like. Limitations of this kind can be preserved in practice no other way than through the medium of courts of justice, whose duty it must be to declare all acts contrary to the manifest tenor of the Constitution void. Without this, all the reservations of particular rights or privileges would amount to nothing.

Some perplexity respecting the rights of the courts to pronounce legislative acts void, because contrary to the Constitution, has arisen from an imagination that the doctrine would imply a superiority of the judiciary to the legislative power. It is urged that the authority which can declare the acts of another void, must necessarily be superior to the one whose acts may be declared void. As this doctrine is of great importance in all the American constitutions, a brief discussion of the ground on which it rests cannot be unacceptable.

There is no position which depends on clearer principles, than that every act of a delegated authority, contrary to the tenor of the commission under which it is exercised, is void. No legislative act, therefore, contrary to the Constitution, can be valid. To deny this, would be to affirm, that the deputy is greater than his principal; that the servant is above his master; that the representatives of the people are superior to the people themselves; that men acting by virtue of powers, may do not only what their powers do not authorize, but what they forbid.

If it be said that the legislative body are themselves the constitutional judges of their own powers, and that the construction they put upon them is conclusive upon the other departments, it may be answered, that this cannot be the natural presumption, where it is not to be collected from any particular provisions in the Constitution. It is not otherwise to be supposed, that the Constitution could intend to enable the representatives of the people to substitute their WILL to that of their constituents. It is far more rational to suppose, that the courts were designed to be an intermediate body between the people and the legislature, in order, among other things, to keep the latter within the limits assigned to their authority. The interpretation of the laws is the proper and peculiar province of the courts. A constitution is, in fact, and must be regarded by the judges, as a fundamental law. It therefore belongs to them to ascertain its meaning, as well as the meaning of any particular act proceeding from the legislative body. If there should happen to be an irreconcilable variance between the two, that which has the superior obligation and validity ought, of course, to be preferred; or, in other words, the Constitution ought to be preferred to the statute, the intention of the people to the intention of their agents.

Nor does this conclusion by any means suppose a superiority of the judicial to the legislative power. It only supposes that the power of the people is superior to both; and that where the will of the legislature, declared in its statutes, stands in opposition to that of the people, declared in the Constitution, the judges ought to be governed by the latter rather than the former. They ought to regulate their decisions by the fundamental laws, rather than by those which are not fundamental.

This exercise of judicial discretion, in determining between two contradictory laws, is exemplified in a familiar instance. It not uncommonly happens, that there are two statutes existing at one time, clashing in whole or in part with each other, and neither of them containing any repealing clause or expression. In such a case, it is the province of the courts to liquidate and fix their meaning and operation. So far as they can, by any fair construction, be reconciled to each other, reason and law conspire to dictate that this should be done; where this is impracticable, it becomes a matter of necessity to give effect to one, in exclusion of the other. The rule which has obtained in the courts for determining their relative validity is, that the last in order of time shall be preferred to the first. But this is a mere rule of construction, not derived from any positive law, but from the nature and reason of the thing. It is a rule not enjoined upon the courts by legislative provision, but adopted by themselves, as consonant to truth and propriety, for the direction of their conduct as interpreters of the law. They thought it reasonable, that between the interfering acts of an EQUAL authority, that which was the last indication of its will should have the preference.

But in regard to the interfering acts of a superior and subordinate authority, of an original and derivative power, the nature and reason of the thing indicate the converse of that rule as proper to be followed. They teach us that the prior act of a superior ought to be preferred to the subsequent act of an inferior and subordinate authority; and that accordingly, whenever a particular statute contravenes the Constitution, it will be the duty of the judicial tribunals to adhere to the latter and disregard the former.

It can be of no weight to say that the courts, on the pretense of a repugnancy, may substitute their own pleasure to the constitutional intentions of the legislature. This might as well happen in the case of two contradictory statutes; or it might as well happen in every adjudication upon any single statute. The courts must declare the sense of the law; and if they should be disposed to exercise WILL instead of JUDGMENT, the consequence would equally be the substitution of their pleasure to that of the legislative body. The observation, if it prove any thing, would prove that there ought to be no judges distinct from that body.

If, then, the courts of justice are to be considered as the bulwarks of a limited Constitution against legislative encroachments, this consideration will afford a strong argument for the permanent tenure of judicial offices, since nothing will contribute so much as this to that independent spirit in the judges which must be essential to the faithful performance of so arduous a duty.

This independence of the judges is equally requisite to guard the Constitution and the rights of individuals from the effects of those ill humors, which the arts of designing men, or the influence of particular conjunctures, sometimes disseminate among the people themselves, and which, though they speedily give place to better information, and more deliberate reflection, have a tendency, in the meantime, to occasion dangerous innovations in the government, and serious oppressions of the minor party in the community. Though I trust the friends of the proposed Constitution will never concur with its enemies,**3** in questioning that fundamental principle of republican government, which admits the right of the people to alter or abolish the established Constitution, whenever they find it inconsistent with their happiness, yet it is not to be inferred from this principle, that the representatives of the people, whenever a momentary inclination happens to lay hold of a majority of their constituents, incompatible with the provisions in the existing Constitution, would, on that account, be justifiable in a violation of those provisions; or that the courts would be under a greater obligation to connive at infractions in this shape, than when they had proceeded wholly from the cabals of the representative body. Until the people have, by some solemn and authoritative act, annulled or changed the established form, it is binding upon themselves collectively, as well as individually; and no presumption, or even knowledge, of their sentiments, can warrant their representatives in a departure from it, prior to such an act. But it is easy to see, that it would require an uncommon portion of fortitude in the judges to do their duty as faithful guardians of the Constitution, where legislative invasions of it had been instigated by the major voice of the community.

But it is not with a view to infractions of the Constitution only, that the independence of the judges may be an essential safeguard against the effects of occasional ill humors in the society. These sometimes extend no farther than to the injury of the private rights of particular classes of citizens, by unjust and partial laws. Here also the firmness of the judicial magistracy is of vast importance in mitigating the severity and confining the operation of such laws. It not only serves to moderate the immediate mischiefs of those which may have been passed, but it operates as a check upon the legislative body in passing them; who, perceiving that obstacles to the success of iniquitous intention are to be expected from the scruples of the courts, are in a manner compelled, by the very motives of the injustice they meditate, to qualify their attempts. This is a circumstance calculated to have more influence upon the character of our governments, than but few may be aware of. The benefits of the integrity and moderation of the judiciary have already been felt in more States than one; and though they may have displeased those whose sinister expectations they may have disappointed, they must have commanded the esteem and applause of all the virtuous and disinterested. Considerate men, of every description, ought to prize whatever will tend to beget or fortify that temper in the courts: as no man can be sure that he may not be to-morrow the victim of a spirit of injustice, by which he may be a gainer to-day. And every man must now feel, that the inevitable tendency of such a spirit is to sap the foundations of public and private confidence, and to introduce in its stead universal distrust and distress.

That inflexible and uniform adherence to the rights of the Constitution, and of individuals, which we perceive to be indispensable in the courts of justice, can certainly not be expected from judges who hold their offices by a temporary commission. Periodical appointments, however regulated, or by whomsoever made, would, in some way or other, be fatal to their necessary independence. If the power of making them was committed either to the Executive or legislature, there would be danger of an improper complaisance to the branch which possessed it; if to both, there would be an unwillingness to hazard the displeasure of either; if to the people, or to persons chosen by them for the special purpose, there would be too great a disposition to consult popularity, to justify a reliance that nothing would be consulted but the Constitution and the laws.

There is yet a further and a weightier reason for the permanency of the judicial offices, which is deducible from the nature of the qualifications they require. It has been frequently remarked, with great propriety, that a voluminous code of laws is one of the inconveniences necessarily connected with the advantages of a free government. To avoid an arbitrary discretion in the courts, it is indispensable that they should be bound down by strict rules and precedents, which serve to define and point out their duty in every particular case that comes before them; and it will readily be conceived from the variety of controversies which grow out of the folly and wickedness of mankind, that the records of those precedents must unavoidably swell to a very considerable bulk, and must demand long and laborious study to acquire a competent knowledge of them. Hence it is, that there can be but few men in the society who will have sufficient skill in the laws to qualify them for the stations of judges. And making the proper deductions for the ordinary depravity of human nature, the number must be still smaller of those who unite the requisite integrity with the requisite knowledge. These considerations apprise us, that the government can have no great option between fit character; and that a temporary duration in office, which would naturally discourage such characters from quitting a lucrative line of practice to accept a seat on the bench, would have a tendency to throw the administration of justice into hands less able, and less well qualified, to conduct it with utility and dignity. In the present circumstances of this country, and in those in which it is likely to be for a long time to come, the disadvantages on this score would be greater than they may at first sight appear; but it must be confessed, that they are far inferior to those which present themselves under the other aspects of the subject.

Upon the whole, there can be no room to doubt that the convention acted wisely in copying from the models of those constitutions which have established GOOD BEHAVIOR as the tenure of their judicial offices, in point of duration; and that so far from being blamable on this account, their plan would have been inexcusably defective, if it had wanted this important feature of good government. The experience of Great Britain affords an illustrious comment on the excellence of the institution.

PUBLIUS.

1 The celebrated Montesquieu, speaking of them, says: "Of the three powers above mentioned, the judiciary is next to nothing." "Spirit of Laws." vol. i., page 186.

2 Idem, page 181.

3 Vide "Protest of the Minority of the Convention of Pennsylvania," Martin's Speech, etc.

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Code

Sec. 1.863-1 Allocation of gross income under section 863(a).

(a) In general.
Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States. See section 1.863-2 for alternate methods to determine the income from sources within or without the United States in the case of items specified in section 1.863-2(a). See also sections 865(b) and (e)(2). In the case of sales of property involving partners and partnerships, the rules of section 1.863-3(g) apply.
(b) Natural resources --

(1) In general
Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale outside the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber within the United States, must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal (as defined in paragraph (b)(3)(iii) of this section). Notwithstanding any other provision, except to the extent provided in paragraph (b)(2) of this section, gross receipts from the sale within the United States of products derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber outside the United States must be allocated between sources within and without the United States based on the fair market value of the product at the export terminal. For place of sale, see sections 1.861-7(c) and 1.863-3(c)(2). The source of gross receipts equal to the fair market value of the product at the export terminal will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of its fair market value at the export terminal (excess gross receipts) will be determined as follows --
(i) If the taxpayer engages in additional production activities subsequent to shipment from the export terminal and outside the country of sale, the source of excess gross receipts must be determined under section 1.863-3. For purposes of applying section 1.863-3, only production assets used in additional production activity subsequent to the export terminal are taken into account.
(ii) In all other cases, excess gross receipts will be from sources within the country of sale. This paragraph (b)(1)(ii) applies to a taxpayer that engages in additional production activities in the country of sale, as well as to a taxpayer that does not engage in additional production activities at all.
(2) Additional production prior to export terminal.

Notwithstanding any other provision of this section, gross receipts from the sale of products derived by a taxpayer who performs additional production activities as defined in paragraph (b)(3)(ii) of this section before the relevant product is shipped from the export terminal are allocated between sources within and without the United States based on the fair market value of the product immediately prior to the additional production activities. The source of gross receipts equal to the fair market value of the product immediately prior to the additional production activities will be from sources where the farm, mine, well, deposit, or uncut timber is located. The source of gross receipts from the sale of the product in excess of the fair market value immediately prior to the additional production activities must be determined under section 1.863-3. For purposes of applying section 1.863-3, only production assets used in the additional production activities are taken into account.

(3) Definitions --

(i) Production activity.

For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See section 1.864-1. Except as otherwise provided in sections 1.1502-13 or 1.863-3(g)(2), only production activities conducted directly by the taxpayer are taken into account.

(ii) Additionalproductionactivities.

For purposes of this section, additional production activities are substantial production activities performed directly by the taxpayer in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. Whether a taxpayer's activities constitute additional production activities will be determined under the principles of section 1.954-3(a)(4). However, in no case will activities that prepare the natural resource itself for export, including those that are designed to facilitate the transportation of the natural resource to or from the export terminal, be considered additional production activities for purposes of this section.

(iii) Export terminal.

Where the farm, mine, well, deposit, or uncut timber is located without the United States, the export terminal will be the final point in a foreign country from which goods are shipped to the United States. If there is no such final point in a foreign country (e.g., the property is extracted and produced on the high seas), the export terminal will be the place of production. Where the farm, mine, well, deposit, or uncut timber is located within the United States, the export terminal will be the final point in the United States from which goods are shipped from the United States to a foreign country. The location of the export terminal is determined without regard to any contractual terms agreed to by the taxpayer and without regard to whether there is an actual sale of the products at the export terminal.

(4) Determination of fair market value.

For purposes of this section, fair market value depends on all of the facts and circumstances as they exist relative to a party in any particular case. Where the products are sold to a related party in a transaction subject to section 482, the determination of fair market value under this section must be consistent with the arm's length price determined under section 482.

(5) Determination of gross income.

To determine the amount of a taxpayer's gross income from sources within or without the United States, the taxpayer's gross receipts from sources within or without the United States determined under this paragraph (b) must be reduced by the cost of goods sold properly attributable to gross receipts from sources within or without the United States.

(6) Tax return disclosure.

A taxpayer that determines the source of its income under this paragraph (b) shall attach a statement to its return explaining the methodology used to determine fair market value under paragraph (b)(4) of this section, and explaining any additional production activities (as defined in paragraph (b)(3)(ii) of this section) performed by the taxpayer. In addition, the taxpayer must provide such other information as is required by section 1.863- 3.

(7) Examples.

The following examples illustrate the rules of this paragraph (b):

Example 1. No additional production.

U.S. Mines, a U.S. corporation, operates a copper mine and mill in country X. U.S. Mines extracts copper-bearing rocks from the ground and transports the rocks to the mill where the rocks are ground and processed to produce copper-bearing concentrate. The concentrate is transported to a port where it is dried in preparation for export, stored and then shipped to purchasers in the United States. Because title to the property is passed in the United States and, under the facts and circumstances, none of U.S. Mine's activities constitutes additional production prior to the export terminal within the meaning of paragraph (b)(3)(ii) of this section, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the concentrate at the export terminal will be from sources without the United States, and excess gross receipts will be from sources within the United States.

Example 2. No additional production.

US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquifiedinpreparation for shipment. The liquified natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under paragraph (b)(1) and (b)(1)(ii) of this section, gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States.

Example 3. Sale in third country.

US Gold, a U.S. corporation, mines gold in country X, produces gold jewelry in the United States, and sells the jewelry in country Y. Assume that the fair market value of the gold at the export terminal in country X is $40, and that US Gold ultimately sells the gold jewelry in country Y for $100. Under section 1.863-1(b), $40 of US Gold's gross receipts will be allocated to sources without the United States. Under paragraph (b)(1)(i) of this section, the source of the remaining $60 of gross receipts will be determined under section 1.863-3. If US Gold applies the 50/50 method described in section 1.863-3, $20 of cost of goods sold is properly attributable to activities subsequent to the export terminal, and all of US Gold's production assets subsequent to the export terminal are located in the United States, then $20 of gross income will be allocated to sources within the United States and $20 of gross income will be allocated to sources without the United States.

Example 4. Production in country of sale.

US Oil, a U.S. corporation, extracts oil in country X, transports the oil via pipeline to the export terminal in country Y, refines the oil in the United States, and sells the refined product in the United States to unrelated persons. Assume that the fair market value of the oil at the export terminal in country Y is $80, and that US Oil ultimately sells the refined product for $100. Under paragraph (b)(1) of this section, $80 of US Oil's gross receipts will be allocated to sources without the United States, and under paragraph (b)(1)(ii) of this section the remaining $20 of gross receipts will be allocated to sources within the United States.

Example 5. Additional production prior to export.

The facts are the same as in Example 1, except that U.S. Mines also operates a smelter in country X. The concentrate output from the mill is transported to the smelter where it is transformed into smelted copper. The smelted copper is exported to purchasers in the United States. Under the facts and circumstances, all of the processes applied to make copper concentrate are considered mining. Therefore, under paragraph (b)(2) of this section, gross receipts equal to the fair market value of the concentrate at the smelter will be from sources without the United States. Under the facts and circumstances, the conversion of the concentrate into smelted copper is an additional production activity in a foreign country within the meaning of paragraph (b)(3)(ii) of this section. Therefore, the source of U.S. Mine's excess gross receipts will be determined pursuant to paragraph (b)(2) of this section.

(c) Determination of taxable income.

The taxpayer's taxable income from sources within or without the United States will be determined under the rules of sections 1.861-8 through 1.861-14T for determining taxable income from sources within the United States.

(d) Scholarships, fellowship grants, grants, prizes and awards --

(1) In general.
This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.
(2) Source of income.
The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:
(i) United states source income.
Except as provided in paragraph (d)(2)(iii) of thissection,scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.
(ii) Foreign source income.
Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency, or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.
(iii) Certain activities conducted outside the United States.
Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.
(3) Definitions.
The following definitions apply for purposes of this paragraph (d):
(i) Scholarships are defined in section 117 and the regulations thereunder.
(ii) Fellowship grants are defined in section 117 and the regulations thereunder.
(iii) Prizes and awards are defined in section 74 and the regulations thereunder.
(iv) Grants are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3)(i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in

advance.

(v) Targeted grants are grants --

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia;

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) Achievement awards are awards --

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(4) Effective dates.

The following are the effective dates concerning this paragraph (d):

(i) Scholarships and fellowship grants.

This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2)(i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) Grants, prizes and awards.

This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

(e) Effective dates.

The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this sectionfortaxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see section 1.863-1 (as contained in 26 CFR part 1 revised as of April 1, 1996).

[T.D. 8615, 60 FR 44274-44275, Aug. 25, 1995; amended by T.D. 8687, 61 FR 60540-60551, Nov. 29, 1996; corrected by 61 FR 65323, Dec. 12, 1996.]

§ 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.

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Notes
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(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).

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Code **Sec. 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.**

(a) In general.

(1) Scope.

Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 871(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) Allocation and apportionment of deductions in general.

A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

(3) Class of gross income.

For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

(i) Compensation for services, including fees, commissions, and similar items;

(ii) Gross income derived from business;

(iii) Gains derived from dealings in property;

(iv) Interest;

(v) Rents;

(vi) Royalties;

(vii) Dividends;

(viii) Alimony and separate maintenance payments;

(ix) Annuities;

(x) Income from life insurance and endowment contracts;

(xi) Pensions;

(xii) Income from discharge of indebtedness;

(xiii) Distributive share of partnership gross income;

(xiv) Income in respect of a decedent;

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

(4) Statutory grouping of gross income and residual grouping of gross income.

For purposes of this section, the term "statutory grouping of gross income" or "statutory grouping" means the gross income from a specific source or activity which must first be determined in order to arrive at "taxable income" from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the "residual grouping of gross income" or "residual grouping." For example, for purposes of determining taxable income from sources within specific foreign countries and possessions of the United States, in order to apply the per-country limitation to the foreign tax credit (as in effect before enactment of the Tax Reform Act of 1976), the statutory groupings are the separate gross incomes from sources within each country and possession. Moreover, if the taxpayer has income subject to section 904(d) (as in effect after enactment of the Tax Reform Act of 1976), such income constitutes one or more separate statutory groupings. In the case of the per-country limitation, the residual grouping is the aggregate of gross income from sources within the United States. In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2) of this section with respect to the allocation and apportionment of deductions to excluded income.

(5) Effective date.

(i) Taxable years beginning after December 31, 1976.

The provisions of this section apply to taxable years beginning after December 31, 1976.

(ii) Taxable years beginning before January 1, 1977.

For taxable years beginning before January 1, 1977, section 1.861-8 applies as in effect on October 23, 1957 (T.D. 6258), as amended on August 22, 1966 (T.D. 6892) and on September 29, 1975 (T.D. 7378). The specific rules for allocation and apportionment of deductions set forth in this section may, at the option of the taxpayer, apply to those taxable years on a deduction-by-deduction basis if the rules are applied consistently to all taxable years with respect to which action by the Internal Revenue Service is not barred by any statute of limitations. Thus, for example, a calendar year taxpayer may choose to have the rules of paragraph (e)(2) of this section apply for the allocation and apportionment of all interest expenses for the two taxable years ending December 31, 1975 and 1976, which are open years under examination, and may justify the allocation and apportionment of all research and development expenses for those years on a basis supportable under section 1.861-8 as in effect for 1975 and 1976 without regard to the rules of paragraph (e)(3) of this section.

(b) Allocation.

(1) In general.

For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxpayable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) Relationship to activity or property.

A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example (17) of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) Supportive functions.[Reserved]

For guidance, see section 1.861-8T(b)(3).

(4) Deductions related to a class of gross income.

See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) Deductions related to all gross income.

If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) Apportionment of deductions.

(1) Deductions definitely related to a class of gross income.

[Reserved] For guidance, see section 1.861-8T(c)(1).

(2) Apportionment based on assets.

[Reserved] For guidance, see section 1.861-8T(c)(2).

(3) Deductions not definitely related to any gross income.

If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(d) Excess of deductions and excluded and eliminated income.

(1) Excess of deductions.

Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See section 1.1502-4(d)(1) and the last sentence of section 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example (17) of paragraph (g) of this section.

(2) Allocation and apportionment to exempt, excluded, or eliminated income.

[Reserved] For guidance, see section 1.861-8T(d)(2).

(e) Allocation and apportionment of certain deductions.

(1) In general.

Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraph (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) Interest.

[Reserved] For guidance, see section 1.861-8T(e)(2).

(3) Research and experimental expenditures.

For rules regarding the allocation and apportionment of research and experimental expenditures, see section 1.861-17.

(4) Stewardship expenses attributable to dividends received.

If a corporation renders services for the benefit of a related corporation and the corporation charges the related corporation for such services (see section 482 and the regulations thereunder which provide for an allocation where the charge is not on an arm's length basis as determined therein), the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (section 1.482-2(b)(2)(ii) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. For example, assume that a related corporation, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs and submits a report of its findings and a plan of borrowing to the parent corporation, and the parent corporation's financial staff reviews the findings and plans to determine whether to advise the related corporation to reconsider its plan. The services of review performed by the parent corporation for its own benefit are of a stewardship or overseeing character. The deductions resulting from stewardship or overseeing functions are incurred as a result of, or incident to, the ownership of the related corporation and, thus, shall be considered definitely related and allocable to dividends received or to be received from the related corporation. If a corporation has a foreign or international department which exercises stewardship or overseeing functions with respect to related foreign corporations and, in addition, the department has other functions which are attributable to other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign royalties, and gross income of foreign branches) to which its deductions are also to be allocated, some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also be attributable to United States source income (such as fees for services performed in the United States) to which its deductions are to be allocated. Methods of apportionment which could possibly be utilized with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See examples (17) and (18) of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship activities.

(5) Legal and accounting fees and expenses.

Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The taxpayer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as "professional," or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) Income taxes.

(i) In general.

The deduction for state, local, and foreign income, war profits and excess profits taxes ("state income taxes") allowed by section 164 shall be considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. For example, if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer's deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income. In allocating and apportioning the deduction for state income tax for purposes including (but not limited to) the computation of the foreign tax credit limitation under section 904 of the Code and the consolidated foreign tax credit under section 1.1502-4 of the regulations, the income upon which the state income tax is imposed is determined by reference to the law of the jurisdiction imposing the tax. Thus, if a state attributes taxable income to a corporate taxpayer by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the corporate taxpayer and engaging in activities related to the business of the corporate taxpayer, then the income so attributed is the income upon which the state income tax is imposed. If the income so attributed to the corporate taxpayer includes foreign source income, then, in computing the taxpayer's foreign tax credit limitation under section 904, for example, the taxpayer's deduction for state income tax will be considered definitely related and allocable to a class of gross income that includes the statutory grouping of foreign source income. When the law of the state includes dividends that are treated under section 862(a)(2) as income from sources without the United States in taxable income apportionable to the state, but does not include factors of the corporation paying such dividends in the apportionment formula used to determine state taxable income, an appropriate portion of the deduction for state income tax will be considered definitely related and allocable to a class of gross income consisting solely of foreign source dividend income. A deduction for state income tax will not be considered definitely related to a hypothetical amount of income calculated under federal tax principles when the jurisdiction imposing the tax computes taxable income under different principles. A corporate taxpayer's deduction for a state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as the deduction for state income taxes. In determining, for example, both the foreign tax credit under section 904 of the Code and the consolidated foreign tax credit limitation under section 1.1502-4 of the regulations, the deduction for state income tax may be allocable and apportionable to foreign source income in a statutory grouping described in section 904(d) in a taxable year in which the taxpayer has no foreign source income in such statutory grouping. Alternatively, such an allocation or apportionment may be appropriate if a taxpayer corporation has no foreign source income in a statutory grouping, but its deduction is attributable to foreign source income in such grouping that is attributed to the taxpayer corporation under the law of a state which attributes taxable income to a corporation by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the taxpayer corporation and engaging in activities related to the business of the taxpayer corporation. Example 30 of paragraph (g) of this section illustrates the application of this last rule.

(ii) Methods of allocation and apportionment.

(A) In general.

A taxpayer's deduction for a state income tax is to be allocated (and then apportioned, if necessary, subject to the rules of section 1.861-8(d)) by reference to the taxable income that the law of the taxing jurisdiction attributes to the taxpayer ("state taxable income").

(B) Effect of subsequent recomputations of state income tax. [Reserved]

(C) Illustrations.

(1) In general.

Examples 25 through 32 of paragraph (g) of section 1.861-8 illustrate, in the given factual situations, the application of this paragraph (e)(6) and the general rule of paragraph (b)(1) of this section that a deduction must be allocated to the class of gross income to which the deduction is factually related. In general, these examples employ a presumption that state income taxes are allocable to a class of gross income that includes the statutory grouping of income from sources without the United States when the total amount of taxable income determined under state law exceeds the amount of taxable income determined under the Code (without taking into account the deduction for state income taxes) in the residual grouping of income from sources within the United States. A taxpayer that allocates and apportions the deduction for state income tax in accordance with the methodology of Example 25 of paragraph (g) of this section must also apply the modifications illustrated in Examples 26 and 27 of paragraph (g) of this section, when applicable. The modification illustrated in Example 26 is applicable when the deduction for state income tax is attributable in part to taxes imposed by a state which factually excludes foreign source income (as determined for federal income tax purposes) from state taxable income. The modification illustrated in Example 27 is applicable when the taxpayer has income-producing activities in a state which does not impose a corporate income tax. The specific allocation of state income tax illustrated in Example 28 follows the rule in paragraph (e)(6)(i) of this section, and must be applied whenever a taxpayer's state taxable income includes dividends apportioned to the state under a formula that does not take into account the factors of the corporations paying those dividends, regardless of whether the taxpayer uses the methodology of Example 25 with respect to the remainder of the deduction for state income taxes.

(2) Modifications.

Before applying a method of allocation and apportionment illustrated in the examples, the computation of state taxable income under state law may be modified, subject to the approval of the District Director, to reflect more accurately the income with respect to which the state income tax is imposed. Any modification to the state law computation of state taxable income must yield an allocation and apportionment of the deduction for state income taxes that is consistent with the rules contained in this paragraph (e)(6), and that accurately reflects the factual relationship between the state income tax and the income on which that tax is imposed. For example, a modification to the computation of taxable income under state law might be appropriate to compensate for differences between the state law definition of taxable income and the federal definition of taxable income, due to a difference in the rate of allowable depreciation or the amount of another deduction that is allowable under both systems. This rule is illustrated in Example 31 of paragraph (g) of this section. However, a modification to the computation of taxable income under state law will not be appropriate, and will not more accurately reflect the factual relationship between the state tax and the income on which the tax is imposed, to the extent such modification reflects the fact that the state does not follow federal tax principles in attributing income to the taxpayer's activities in the state. This rule is illustrated in Example 32 of paragraph (g) of this section. A taxpayer may not modify the methods illustrated in the examples, or use an alternative method of allocation and apportionment of the deduction for state income taxes, if the modification or alternative method would be inconsistent with the rules of paragraph (e)(6)(i) of this section. A taxpayer that uses a method of allocation and apportionment other than one illustrated in Example 25 (as modified by Examples 26 and 27), or 29 with respect to a factual situation similar to those of the examples, must describe the alternative method on an attachment to its federal income tax return and establish to the satisfaction of the District Director, upon examination, that the result of the alternative method more accurately reflects the factual relationship between the state income tax and the income on which the tax is imposed.

(D) Elective safe harbor methods.

(1) In general.

In lieu of applying the rules set forth in paragraphs (e)(6)(ii) (A) through (C) of this section, a taxpayer may elect to allocate and apportion the deduction for state income tax in accordance with one of the two safe harbor methods described in paragraph (e)(6)(ii)(D) (2) and (3) of this section. A taxpayer shall make this election for a taxable year by filing a timely tax return for that year that reflects an allocation and apportionment of the deduction for state income tax under one of the safe harbor methods and attaching to such return a statement that the taxpayer has elected to use the safe harbor method provided in either paragraph (e)(6)(ii)(D) (2) or (3) of this section, as appropriate. Once made, this election is effective for the taxable year for which made and all subsequent taxable years, and may be revoked only with the consent of the Commissioner. Example 33 of paragraph (g) of this section illustrates the application of these safe harbor methods.

(2) Method One.

(i) Step One--Specific allocation to foreign source portfolio dividends and other income.

If any portion of the deduction for state income tax is attributable to tax imposed by a state which includes in a corporate taxpayer's taxable income apportionable to the state, portfolio dividends (as defined in paragraph (i) of Example 28 of paragraph (g) of this section) that are treated under section 862(a)(2) as income from sources without the United States, but does not include factors of the corporations paying the portfolio dividends in the apportionment formula used to determine state taxable income, the taxpayer shall allocate an appropriate portion of the deduction to a class of gross income consisting solely of foreign source portfolio dividends. The portion of the deduction so allocated, and the amount of foreign source portfolio dividends included in such class, shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 28 of paragraph (g). If a state income tax is determined based upon formulary apportionment of the total taxable income attributable to the taxpayer's unitary business, the taxpayer must also apply the methodology illustrated in paragraph (ii)(C) through (G) of Example 29 of paragraph (g) of this section to make specific allocations of appropriate portions of the deduction for state income tax on the basis of income that, under separate accounting, would have been attributed to other members of the unitary group. The taxpayer shall reduce its aggregate state taxable income by the amount of foreign source portfolio dividends to which a specific allocation is made (the reduced amount being referred to hereinafter as "adjusted state taxable income").

(ii) Step Two--Adjustment of U.S. source federal taxable income.

If the taxpayer has significant income-producing activities in a state which does not impose a corporate income tax or other state tax measured by income derived from business activities in the state, the taxpayer shall reduce its U.S. source federal taxable income (solely for purposes of this safe harbor method) by the amount of federal taxable income attributable to its activities in such state. This amount shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 27 of paragraph (g) of this section, provided that the taxpayer shall be required to use the rules of the Uniform Division of Income for Tax Purposes Act to attribute income to the relevant state. The taxpayer's U.S. source federal taxable income, as so reduced, is referred to hereinafter as "adjusted U.S. source federal taxable income."

(iii) Step Three--Allocation.

The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to an amount equal to 110% of its adjusted U.S. source federal taxable income.

(iv) Step Four--Apportionment.

In the event that apportionment of the remainder of the deduction for state income tax is required, the taxpayer shall apportion that remaining deduction to U.S. source income in accordance with the methodology illustrated in paragraph (iii) of Example 25 of paragraph (g) of this section, substituting for domestic source income in that paragraph an amount equal to 110% of the taxpayer's adjusted U.S. source federal taxable income. The remaining portion of the deduction shall be apportioned to the statutory groupings of foreign source income described in section 904(d) of the Code in accordance with the proportion of the income in each statutory grouping of foreign source income described in section 904(d) to the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above).

(3) Method Two.

(i) Step One--Specific allocation to foreign source portfolio dividends and other income.

Step One of this method is the same as Step One of Method One (as described in paragraph (e)(6)(ii)(D)(2)(i) of this section).

(ii) Step Two--Adjustment of U.S. source federal taxable income.

Step Two of this method is the same as Step Two of Method One (as described in paragraph (e)(6)(ii)(D)(2)(ii) of this section).

(iii) Step Three--Allocation.

The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to its adjusted U.S. source federal taxable income.

(iv) Step Four--Apportionment.

In the event that apportionment of the deduction is required, the taxpayer shall apportion to U.S. source income that portion of the deduction that is attributable to state income taxes imposed upon an amount of state taxable income equal to adjusted U.S. source federal taxable income. The taxpayer shall apportion the remaining amount of the deduction to U.S. and foreign source income in the same proportions that the taxpayer's adjusted U.S. source federal taxable income and foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) bear to its total federal taxable income (taking into account the adjustment of U.S. source federal taxable income under Step Two and after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One). The portion of the deduction apportioned to foreign source income shall be apportioned among the statutory groupings described in section 904(d) of the Code in accordance with the proportions of the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) in each grouping.

(iii) Effective dates.

The rules of section 1.861-8(e)(6)(i) and the language preceding the examples in section 1.861-8(g) are effective for taxable years beginning after December 31, 1976. The rules of section 1.861-8(e)(6)(ii) (other than section 1.861-8(e)(6)(ii)(D)) and Examples 25 through 32 of section 1.861-8(g) are effective for taxable years beginning on or after January 1, 1988. The rules of section 1.861-8(e)(6)(ii)(D) and Example 33 of section 1.861-8(g) are effective for taxable years ending after March 12, 1991. At the option of the taxpayer, however, the rules of section 1.861-8(e)(6)(ii) (other than section 1.861-8(e)(6)(ii)(D)) and Examples 25 through 32 of section 1.861-8(g) may be applied with respect to deductions for state taxes incurred in taxable years beginning before January 1, 1988.

(7) Losses on the sale, exchange, or other disposition of property.

(i) Allocation.

The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from the asset or property during the taxable year or years immediately preceding the sale, exchange, or other disposition of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) Apportionment of losses.

Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) Allocation of loss recognized in taxable years after 1986.

See Secs. 1.865-1T, 1.865-2, and 1.865-2T for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) Net operating loss deduction. [Reserved.]

For guidance, see Sec. 1.861-8T(e)(8).

(9) Deductions which are not definitely related.

Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are--

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213;

(iv) The deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B); and

(v) The deduction for alimony payments allowed by section 215.

(10) Special deductions.

The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) Personal exemptions.

The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(f) Miscellaneous matters.

(1) Operative sections.

The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) Overall limitation to the foreign tax credit.

Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and sections 1.862-1 and 1.863-1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example (3) of paragraph (g) of this section for one example of the application of this section to the overall limitation.

(ii)[Reserved]

(iii) DISC and FSC taxable income.

Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See Examples (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the "no loss" rules of the regulations under sections 925 and 994.

(iv) Effectively connected taxable income.

Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see section 1.882-5)) which are to be taken into account in determining taxable income. See example (21) of paragraph (g) of this section.

(v) Foreign base company income.

Section 954 defines the term "foreign base company income" with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation "properly allocable to such income". This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) Other operative sections.

The rules provided in this section also apply in determining--

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C)[Reserved]

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;

(H) The income derived from Guam by an individual who is subject to section 935;

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the Subpart F income of a controlled foreign corporation under section 952(b);

(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, Part 3). See 26 CFR 3.2(b)(3).

(2) Application to more than one operative section.

(i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, Example (22) of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to

DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the extent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not apply to the extent that the foreign trade income of the FSC or former FSC is determined under the section 925(a)(3) transfer pricing method. See Example (23) of paragraph (g) of this section.

(3) Special rules of section 863(b).

(i) In general.

Special rules under section 863(b) provide for the application of rules of general apportionment provided in sections 1.863-3 to 1.863-5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income to foreign sources. The activities specified in section 863(b) are--

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in sections 1.863-3 and 1.863-4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) Relationship of sections 861, 862, 863(a), and 863(b).

Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) Adjustments made under other provisions of the Code.

(i) In general.

If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the District Director shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the District Director to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent continues to incur expenses in connection with the supervision of the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the District Director to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) Example.

X, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. X reported $1,500,000 as sales during the taxable year of which $1,000,000 was domestic sales and $500,000 was foreign sales. X took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. Thus, X allocated and apportioned the marketing department deduction as follows:

```
To gross income from domestic sales:

  $150,000 x ($1,000,000/$1,500,000)        $100,000

To gross income from foreign sales:

  $150,000 x ($500,000/$1,500,000)            50,000

                                             --------

     Total                                   150,000
```

On audit of X's return for the taxable year, the District Director adjusted, under section 482, X's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000, thereby increasing X's foreign sales and total sales by the same amount. As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

```
To gross income from domestic sales:

  $150,000 x ($1,000,000/$1,600,000)        $93,750

To gross income from foreign sales:
```

```
$150,000 x ($600,000/$1,600,000)          56,250
                                         --------
   Total                                 150,000
```

(5) Verification of allocations and apportionments.

Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) General examples.

The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of section 1.861-8). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

Example 1--[Reserved]

Example 2--[Reserved]

Example 3--[Reserved]

Example 4--[Reserved]

Example 5--[Reserved]

Example 6--[Reserved]

Example 7--[Reserved]

Example 8--[Reserved]

Example 9--[Reserved]

Example 10--[Reserved]

Example 11--[Reserved]

Example 12--[Reserved]

Example 13--[Reserved]

Example 14--[Reserved]

Example 15--[Reserved]

Example 16--[Reserved]

Example 17--Stewardship Expenses (Consolidation).

(i) Facts.

X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
	---------	---------
Total	550,000	370,000

Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitute stewardship expenses. The remainder of X's deductions ($20,000) relates to production of income from its plant in the United States.

(ii) Allocation.

In accordance with section 1.1502-4, each corporation must first compute its separate taxable income for purposes of computing the limitation on the foreign tax credit. X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to income earned from sources without the United States and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the overall limitation, the statutory grouping is gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, X, M, and N have separate taxable income (losses) from sources without the United States in the amounts of ($25,000), $150,000, and ($50,000), respectively, computed as follows:

	X	M	N

Foreign gross income	------	$250,000	$150,000
Less: Deductions allocable to foreign gross income	$25,000	100,000	200,000
	---------	--------	--------
Total, taxable income (loss)	(25,000)	150,000	(50,000)

Thus, in the combined computation of the overall limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000 ($150,000 of separate taxable income of M less $50,000 of losses of N and less $25,000 of losses of X).

Example 18--Stewardship and Supportive Expenses.

(i) Facts.

X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year. X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed in the United States	1,000,000

Total gross income	40,000,000
Among other deductions, X incurs the following:	
Expenses of supervision department	1,600,000
Charitable contributions	100,000

X's Supervision Department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $1,000,000. The second type consists of stewardship activities which are in the nature of a management review and generally duplicate functions performed by the subsidiaries' own employees (and are, therefore, of a type described in section 1.482-2(b)(2)(ii) which would not be subject to an allocation under section 482). For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) Allocation.

The Department's outlay of $1,000,000 is the basis for the charge to U for services rendered, and therefore $1,000,000 is allocated to the fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U and V and royalties from t and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary services and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) Apportionment.

For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Supervision Department expenses and related supportive expenses which is allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the overall limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

The gross receipts of the subsidiaries were as follows:

S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000

Total	9,000,000

Thus, the expenses of the Department are apportioned for purposes of the overall limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income:	
540,000 x [($3,000,000 + $500,000 + $1,500,000)/ $9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income:	

$540,000 x $4,000,000/9,000,000	240,000

Total: Apportioned stewardship expense	$540,000

(iv) Allocation and apportionment of charitable contributions.

Pursuant to paragraph (e)(9) of this section, charitable contributions are generally treated as deductions which are not definitely related to any gross income and are, accordingly, apportioned ratably on the basis of gross income for purposes of the overall limitation as follows:

Apportionment of charitable contributions	
to the statutory grouping of gross income:	
$100,000 x [($2,000,000 + $1,000,000 +	
$1,000,000)/$40,000,000]	$10,000
Apportionment of charitable contributions	
to the residual grouping of gross income:	
$100,000 x [($32,000,000 + $3,000,000 +	
$1,000,000)/$40,000,000]	90,000

Total apportioned charitable contributions	100,000

Example 19--Supportive Expense.

(i) Facts.

X, a domestic corporation, purchases and sells products both in the United States and in foreign countries. X has no foreign subsidiary and no international department. During the taxable year, X incurs the following expenses with respect to its worldwide activities:

Personnel department expenses	$50,000
Training department expenses	35,000
General and administrative expenses	55,000

President's salary	40,000
Sales manager's salary	20,000

Total	200,000
	=========

X has domestic gross receipts from sales of $750,000 and foreign gross receipts from sales of $500,000 and has gross income from such sales in the same ratio, namely $300,000 from domestic sources and $200,000 from foreign sources.

(ii) Allocation.

The above expenses are definitely related and allocable to all of X's gross income derived from both domestic and foreign markets.

(iii) Apportionment.

For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deductions for its worldwide sales activities must be apportioned between these groupings. Company X in this example (unlike Company X in example (18)) does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000 deduction is as follows:

```
Apportionment of the $200,000 expense
  to the statutory grouping of
  gross income: $200,000 x
 [$500,000/($500,000 + $750,000)]           $80,000
```

```
Apportionment of the $200,000 expense to
            the residual grouping of gross income:
           $200,000 x [$750,000/($500,000 + $750,000)] 120,000
                                                       ---------
               Total apportioned supportive expense    200,000
```

Example 20--Supportive Expense.

(i) Facts.

Assume the same facts as above except that X's president devotes only 5 percent of his time to the foreign operations and 95 percent of his time to the domestic operations and that X's sales manager devotes approximately 10 percent of his time to foreign sales and 90 percent of his time to domestic sales.

(ii) Allocation.

The expenses incurred by X with respect to its worldwide activities are definitely related, and therefore allocable to X's gross income from both its foreign and domestic markets.

(iii) Apportionment.

On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

```
Apportionment of the $200,000 expense to
  the statutory grouping of gross income:
     President's salary: $40,000 x 5 pct      $2,000
     Sales manager's salary: $20,000 x 10 pct  2,000
     Remaining expenses: $140,000 x
     [$500,000/($500,000 + $750,000)]         56,000
```

```
                                                   --------
Subtotal: Apportionment of expense to
  statutory grouping                                60,000
                                                   ========
Apportionment of the $200,000 expense to
  the residual grouping of gross income:
     President's salary: $40,000 x 95 pct     38,000
     Sales manager's salary: $20,000 x 90 pct 18,000
     Remaining expenses: $140,000 x
       [$750,000/($500,000+$750,000)]         84,000
                                                   --------
Subtotal: Apportionment of expense to
  residual grouping                                140,000
                                                  =========
Total: Apportioned general and
  administrative expense                           200,000
```

Example 21--Supportive Expense.

(i) Facts.

X, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. X has no United States subsidiaries and no separate division to manage and oversee its business in the United States. X manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are X's only source of income. In 1977, X incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000. It has machine sales of $500,000, $1,000,000 and $1,000,000 on which it earns gross income of $200,000, $400,000 and $400,000 in the United States, country A, and country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with X's business in the United

States.

(ii) Allocation.

The $100,000 of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in country A, and in country B. The expenses are allocable to this class of income, even though X's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(iii) Apportionment.

Since X is a foreign corporation, the statutory grouping is gross income effectively connected with X's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts which would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

```
                Apportionment of general and administrative
                  expense to the statutory grouping, gross
                  income from sources within the United
                  States: $100,000 x [$200,000/
                  ($200,000 + $400,000 + $400,000)]         $20,000
           Apportionment of general and administrative
                  expense to the residual grouping, gross
                  income from sources without the United
                  States: $100,000 x [($400,000 + $400,000)/
                  ($200,000 + $400,000 + $400,000)]          80,000
                                                            --------
                     Total apportioned general and
```

administrative expense 100,000

Example 22--Domestic International Sales Corporations.

(i) Facts.

X, a domestic corporation, manufactures a line of kitchenware and sells it to retailers in the United States, France, and the United Kingdom. After the Domestic International Sales Corporation (DISC) legislation was passed in 1971, X established, as of January 1, 1972, a DISC and thereafter did all of its foreign marketing through sales by the DISC. In 1977 the DISC has total sales of $7,700,000 for which X's cost of goods sold is $6,000,000. Thus, the gross income attributable to exports through the DISC is $1,700,000 ($7,700,000-$6,000,000). Moreover, X has U.S. domestic sales of kitchenware of $12,000,000 on which it earned gross income of $900,000, and X receives royalty income from the foreign license of its kitchenware technology in the amount of $800,000. The DISC's expenses attributable to the resale of export property are $400,000 of which $300,000 qualify as export promotion expenses. X also incurs $125,000 of general and administrative expenses in connection with its domestic and foreign sales activities, and its foreign licensing activities. X and the DISC determine transfer prices charged on the basis of a single product grouping and the "50-50" combined taxable income method (without marginal costing) which permits the DISC to have a taxable income equal to 50 percent of the combined taxable income attributable to the production and sales of the export property, plus 10 percent of the DISC's export promotion expenses.

(ii) Allocation.

For purposes of determining combined taxable income of X and the DISC from export sales, general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of kitchenware for export, and from the production and sale of kitchenware for the domestic market. The deduction of $400,000 for expenses attributable to the resale of export property is allocated solely to gross income from the production and sale of kitchenware in foreign markets.

(iii) Apportionment.

Apportionment of expense takes place in two stages. In the first stage, for computing combined taxable income from the production and sale of export property, the general and administrative expense should be apportioned between the statutory grouping of gross income from the export of kitchenware and the residual grouping of gross income from domestic sales and foreign licenses. In the second stage, since the limitation on the foreign tax credit requires the use of a separate limitation with respect to dividends from a DISC (section 904(d)), the general and administrative expense should be apportioned between two statutory groupings, DISC dividends and foreign royalty income (for which the overall limitation is used), and the residual grouping of gross income from sales within the United States. In the first stage, in the absence of more specific or contrary information, the general and administrative expense may be apportioned on the basis of gross income in the respective groupings, as follows:

```
Apportionment of general and administrative
       expense to the statutory grouping, gross
       income from exports of kitchenware:
       $125,000 x [$1,700,000/
       ($1,700,000 + $900,000 + $800,000)]        $62,500
     Apportionment of general and administrative
       expense to the residual grouping, gross
       income from domestic sales of kitchenware
       and foreign royalty income from licensing
       kitchenware technology: $125,000 x
       [($900,000 + $800,000)/
       ($1,700,000 + $900,000 + $800,000)]         62,500
                                                  --------
          Total apportionment of general and
            administrative expense                125,000
```

On the basis of this apportionment, the combined taxable income, and the DISC portion of taxable income may be calculated as follows:

```
Gross income from exports       $1,700,000
Less:
     DISC expense for resale
```

```
          of export property           400,000


          Apportioned general and

           administrative expense        62,500

                                       ---------

                                                  $462,500

                                                  ---------

     Combined taxable income from production

     and export of kitchenware                   1,237,500

                                                 ==========

     DISC income:

          50 pct of combined taxable income        618,750

          10 pct of export promotion expense

            of $300,000                             30,000

                                                  ---------

          Total DISC income                        648,750

     DISC income as a percentage of combined

       taxable income                                 52.4
```

In the second stage, in the absence of more specific or contrary information, the general and administrative expense may also be apportioned on the basis of gross income in the respective groupings. Since DISC taxable income is 52.4 percent of combined taxable income, DISC gross income is treated as 52.4 percent of the gross income from exports $1,700,000. The apportionment follows:

```
     Apportionment of general and administrative

       expense to the statutory grouping, DISC
```

```
  dividends: $125,000 x [(0.524 x $1,700,000)/
  ($1,700,000 + $900,000 + $800,000)]          $32,750
Apportionment of general and administrative
  expense to the statutory grouping, foreign
  royalty income: $125,000 x [$800,000/
  ($1,700,000 + 900,000 + $800,000)]            29,412
Apportionment of general and administrative
  expense to the residual grouping, gross
  income from sources within the United
  States: $125,000 x [($900,000 + (0.476  x
  $1,700,000))/($1,700,000 + $900,000 +
  $800,000)]                                    62,838
                                              --------
 Total apportioned general and
   administrative expense                      125,000
```

(iv) This Example (22) applies only to DISC taxable years ending before January 1, 1987, and to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years ending before January 1, 1987.

Example 23--[Reserved]

Example 24--[Reserved] For guidance, see section 1.861-8T(g) Example 24.

Example 25--Income Taxes.

(i) Facts.

X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1988, X has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of

$1,000,000, of which $200,000 is foreign source general limitation income subject to a separate limitation under section 904(d)(1)(I) ("general limitation income") and $800,000 is domestic source income. States A, B, and C each determine X's income subject to tax within their state by making adjustments to X's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of X's payroll, property, and sales within each state as compared to X's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that X has taxable income of $550,000, $200,000, and $200,000 in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, and X has total state income tax liabilities of $69,000 ($55,000 + $10,000 + $4,000), which it deducts as an expense for federal income tax purposes.

(ii) Allocation.

X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000 of X's income while only $800,000 is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000 of foreign source income. The deduction for state income taxes is therefore related and allocable to both X's foreign source and domestic source income.

(iii) Apportionment.

For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on $800,000 of domestic source income and $150,000 of foreign source general limitation income.

```
State income tax deduction apportioned

            to foreign source general limitation

            income (statutory grouping):
```

```
    $69,000 x ($150,000/$950,000)             $10,895

  State income tax deduction apportioned

    to income from sources within the United

    States (residual grouping):

    $69,000 x ($800,000/$950,000)              58,105

                                             ---------

       Total apportioned state income

         tax deduction                        $69,000
```

Example 26--Income Taxes.

(i) Facts.

Assume the same facts as in Example 25 except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to X's country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) Allocation.

X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000 of X's $800,000 of domestic source income. X's state A tax of $55,000 is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000 ($200,000 + $200,000) of X's income of which only $250,000 ($800,000 - $550,000) is presumed to be domestic source, the deduction for the $14,000 of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(iii) Apportionment.

(A) For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000 for income taxes of states

B and C must be apportioned between these two groupings.

(B) Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation income and U.S. source income subject to state taxation.

```
States B and C income tax deduction
  apportioned to foreign source general
  limitation income (statutory grouping):
  $14,000  x  ($150,000/$400,000)             $5,250
States B and C income tax deduction
  apportioned to income from sources within
  the United States (residual grouping):
  $14,000  x  ($250,000/$400,000)              8,750
                                            ----------
     Total apportioned state income
       tax deduction                         $14,000
```

(C) Of X's total income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $5,250. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750 ($55,000 + $8,750).

Example 27-- Income Tax--

(i) Facts.

Assume the same facts as in Example 25 except that state A, in which X has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. X therefore has a total state income tax liability in 1988 of $14,000 ($10,000 paid to state B plus $4,000 paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) Allocation.

(A) X's deduction of $14,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the federal income tax return in the manner described in Examples 25 and 26. Unlike the facts in Examples 25 and 26, state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of X's income subject to state taxation is, therefore, $400,000 ($200,000 in state B and $200,000 in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore can not properly be compared to total U.S. source taxable income reported by X for federal income tax purposes, which does include income attributable to state A activities.

(B)(1) Accordingly, before applying the method used in Examples 25 and 26 to the facts of this example, it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to X's activities in state A, and then to reduce federal taxable income by that amount.

(2) Any reasonable method may be used to attribute taxable income to X's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA") attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts--property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales--and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in this example all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to X's country Y branch must be eliminated.

(C)(1) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by X's country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(2) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by X's country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of X's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in Example 26 must then be applied.

(3) If, for example, state A taxable income were determined to equal $550,000, then $550,000 of

U.S. source income for federal income tax purposes would be presumed to constitute state A taxable income. Under Example 26, the remaining $250,000 ($800,000 - $550,000) of U.S. source income for federal income tax purposes would be presumed to be subject to tax in states B and C. Since states B and C impose tax on $400,000, the application of Example 25 would result in a presumption that $150,000 is foreign source income and $250,000 is domestic source income. The deduction for the $14,000 of income taxes of states B and C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(iii) Apportionment.

The deduction of $14,000 for income taxes of states B and C is apportioned in the same manner as in Example 26. As a result, $5,250 of the $14,000 of state B and state C income taxes is apportioned to foreign source general limitation income ($14,000 x $150,000/$400,000), and $8,750 ($14,000 x $250,000/$400,000) of the $14,000 of state B and state C income taxes is apportioned to U.S. source income.

Example 28--Income Tax--

(i) Facts.

(A) Assume the same facts as in Example 25 (X has $1,000,000 of taxable income for federal income tax purposes, $800,000 of which is U.S. source income and $200,000 of which is foreign source general limitation income), except that $100,000 of X's $200,000 of foreign source general limitation income consists of dividends from first-tier controlled foreign corporations ("CFCs") (as defined in section 957(a) of the Code) which derive exclusively foreign source general limitation income. X owns stock representing 10 to 50 percent of the vote and value in such CFCs.

(B) State A taxable income is computed by first making adjustments to X's federal taxable income. These adjustments result in X having a total of $1,100,000 of apportionable taxable income for state A tax purposes. None of the $100,000 of adjustments made by state A relate to the dividends paid by the CFCs. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the "state apportionment fraction") that compares the relative amounts of X's payroll, property, and sales within state A with X's worldwide payroll, property and sales. An analysis of state A law indicates that state A law includes in its definition of the taxable business income of X which is apportionable to X's state A activities, dividends paid to X by its subsidiaries that are in the same business as X, but are less than 50 percent owned by X ("portfolio dividends"). The dividends received by X from the 10 to 50 percent owned first-tier CFCs, therefore, are considered to be portfolio dividends includable in apportionable business income for state A tax purposes. However, the factors of these CFCs are not included in the state A apportionment fraction for purposes of apportioning income to X's activities in the state. The comparison of X's state A factors with X's worldwide factors results in a state apportionment fraction of 50 percent. Applying this fraction to apportionable taxable income of $1,100,000, as determined under state law, results in attributing 50 percent of apportionable taxable income to state A, and produces total state A taxable income of $550,000. State A imposes an income tax at a rate of 10 percent on the amount of income that is attributed to state A, which results in $55,000 of tax imposed by state A.

(ii) Allocation.

(A) States A, B, and C impose income taxes of $69,000 which must be allocated to the classes of gross income upon which the taxes are imposed. A portion of X's federal income tax deduction of $55,000 for state A income tax is definitely related and thus allocable to the class of gross income consisting of foreign source portfolio dividends. A definite relationship exists between a deduction for state income tax and portfolio dividends when a state includes portfolio dividends in state taxable income apportionable to the state, but determines state taxable income by applying an apportionment fraction that excludes the factors of the corporations paying those dividends. By applying a state apportionment fraction that excludes factors of the corporations paying portfolio dividends to apportionable taxable income that includes the $100,000 of foreign source portfolio dividends, $50,000 (50 percent of the $100,000) of the portfolio dividends is attributed to X's activities in state A and subjected to state A income tax. Applying the state A income tax rate of 10 percent to the $50,000 of foreign source portfolio dividends subjected to state A income tax, $5,000 of X's $55,000 total state A income tax liability is definitely related and allocable to a class of gross income consisting of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends from the first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $5,000 of state A tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned. (If the total amount of state A tax imposed on foreign source portfolio dividends were to exceed the actual amount of X's state A income tax liability (for example, due to net operating losses), the actual amount of state A tax would be allocated entirely to those foreign source portfolio dividends.) After allocation of a portion of the state A tax to portfolio dividends, $50,000 ($55,000-$5,000) of state A tax remains to be allocated.

(B) A total of $64,000 (the aggregate of the $50,000 remaining state A tax, and the $10,000 and $4,000 of taxes imposed by states B and C, respectively) is to be allocated (as provided in Example 25) by comparing U.S. source taxable income (as determined under the Code) with the aggregate of the state taxable incomes determined by states A, B, and C (after reducing state apportionable taxable incomes by the amount of any portfolio dividends included in apportionable taxable income to which tax has been specifically allocated). X's state A taxable income, after reduction by the $50,000 of portfolio dividends taxed by state A, equals $500,000. X also has taxable income of $200,000 and $200,000 in states B and C, respectively. In the aggregate, therefore, states A, B, and C tax $900,000 of X's income, after excluding state taxable income attributable to portfolio dividends. Since X has only $800,000 of U.S. source taxable income for federal income tax purposes, it is presumed that state income taxes are imposed on $100,000 of foreign source income. The remaining deduction of $64,000 for state income taxes is therefore related and allocable to both foreign source and domestic source income and is subject to apportionment.

(iii) Apportionment.

For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation income, and one residual grouping, gross income from sources within the United States. The remaining state income tax deduction of $64,000 must be apportioned between these two groupings on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, the $64,000 of state income taxes is considered to be imposed on $800,000 of domestic source income and $100,000 of foreign source general limitation income and is apportioned as follows:

```
State income tax deduction apportioned

            to foreign source general limitation

            income (statutory grouping):

            $64,000  x  ($100,000/$900,000)             $7,111

          State income tax deduction apportioned

            to income from sources within the

            United States (residual grouping):

            $64,000  x  ($800,000/$900,000)              56,889

                                                       ---------

               Total apportioned state income

                 tax deduction                          $64,000
```

Of the total state income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $12,111 ($5,000 + $7,111). The total amount of state income taxes allocated and apportioned to U.S. source income equals $56,889.

Example 29--Income Taxes--

(i) Facts.

(A) P, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states F, G, and H. P also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In addition, P has three wholly owned subsidiaries, US1, US2, and FS, the latter a controlled foreign corporation ("CFC") as defined in section 957(a) of the Code. P also owns stock representing 10 to 50 percent of the vote and value of various other first-tier CFCs that derive exclusively foreign source general limitation income.

(B) In 1988, P derives $1,000,000 of federal taxable income (without taking into account the deduction for state income taxes), which consists of $250,000 of foreign source general limitation income and $750,000 of U.S. source income. The foreign source general limitation income consists of a $25,000 subpart F inclusion with respect to FS, $150,000 of dividends from the other first-tier CFCs deriving exclusively foreign source general limitation income, in which P owns stock representing 10 to 50 percent of the vote and value, and $75,000 of manufacturing and sales income derived by P's U.S. operations and country Y branch. The $750,000 of U.S. source income consists of manufacturing and sales income derived by P's U.S. operations.

(C) For federal income tax purposes, US1 derives $75,000 of taxable income, before deduction for state income taxes, which consists entirely of U.S. source income. US2, a so-called "80/20' corporation described in section 861(c)(1), derives $250,000 of federal taxable income before deduction for state or foreign income taxes, all of which is derived from foreign operations and consists entirely of foreign source general limitation income. FS is not engaged in a U.S. trade or business and derives $550,000 of foreign source general limitation income before deduction for foreign income taxes.

(D) State F imposes a corporate income tax of 10 percent of P's state F taxable income, which is determined by formulary apportionment of the total taxable income attributable to P's worldwide unitary business. State F determines P's taxable income for state F tax purposes by first making adjustments to the taxable income, as determined for federal income tax purposes, of the members of the unitary business group to determine the total taxable income of the group. State F then computes P's state taxable income by attributing a portion of that unitary business taxable income to activities of P that are conducted in state F. State F does this by multiplying the unitary business taxable income (federal taxable income with state adjustments) by a fraction (the 'state apportionment fraction") that compares the relative amounts of the unitary business group's payroll, property, and sales (the "factors") in state F with the payroll, property, and sales of the unitary business group. P is the only member of its unitary business group that has state F factors and that is thereby subject to state F income tax and filing requirements. State F defines the unitary business group to include any corporation more than 50 percent of which is directly or indirectly owned by a state F taxpayer and is engaged in the same unitary business. P's unitary business group, therefore, includes P, US1, US2, and FS, but does not include the 10 to 50 percent owned CFCs. The income of the unitary business group excludes intercompany dividends between members of the unitary business group and subpart F inclusions with respect to a member of the unitary business group. Dividends paid from nonmembers of the unitary group (the 10 to 50 percent owned CFCs) for state F tax purposes are referred to as "portfolio dividends" and are included in taxable income of the unitary business. None of the factors (in state F or worldwide) of the corporations paying portfolio dividends are included in the state F apportionment fraction for purposes of apportioning total taxable income of the unitary business to P's state F activities.

(E) After state adjustments to the taxable income of the unitary business group, as determined under federal tax principles, the total taxable income of P's unitary business group equals $2,000,000, consisting of $1,050,000 of P's income ($100,000 of foreign source manufacturing and sales income, $150,000 of foreign source portfolio dividends, and $800,000 of U.S. source manufacturing and sales income, but excluding the $25,000 subpart F inclusion attributable to FS since FS is a member of the unitary business group), $100,000 of US1's income (from sales made in the United States), $275,000 of US2's income (from an active business outside the United States), and $575,000 of FS's income. The differences between taxable income under federal tax principles and state F apportionable taxable income for P, US1, US2, and FS represent adjustments to taxable income under federal tax principles that are made pursuant to the tax laws of state F.

(F) The taxable income for each member of the unitary business group under federal tax principles and state law principles is summarized in the following table. (The items of income listed in the "Federal" column of the table refer to taxable income before deduction for state income tax.)

	Federal	State F
P		

U.S. source income	$750,000	$800,000
Foreign source general		
limitation income:		
Portfolio dividends	150,000	150,000
Subpart F income	25,000	0
Manufacturing and sales		
income	75,000	100,000
	-----------	----------
Total taxable income	1,000,000	1,050,000
US1		
U.S. source income	75,000	100,000
US2		
Foreign source general		
limitation income	250,000	275,000
FS		
Foreign source general		
limitation income	550,000	575,000
	-----------	----------
Taxable income of the		
unitary business group	-------	2,000,000
	===========	==========

(G) State F deems P to have state F taxable income of $500,000, which is determined by multiplying the total taxable income of the unitary business group ($2,000,000) by the group's state F apportionment fraction, which is assumed to be 25 percent in these facts. P's state F taxable income is then multiplied by the state F tax rate of 10 percent, resulting in a state F tax liability of $50,000. State G and state H, unlike state F, do not tax portfolio dividends. Although state G and state H apportion taxable income, respectively, on the basis of an apportionment fraction that compares state factors to total factors, state G and state H, unlike state F, do not apply a unitary business theory and consider only P's taxable income and factors in computing P's taxable income. P's taxable income under state G law equals $300,000, which is subject to a 5 percent tax rate resulting in a state G tax liability of $15,000. P's taxable income under state H law is $300,000, which is subject to a tax rate of 2 percent resulting in a state H tax liability of $6,000. P has a total federal income tax deduction for state income taxes of $71,000 ($50,000 + 15,000 + 6,000).

(ii) Allocation.

(A) P's deduction of $71,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. Adjustments may be necessary, however, before aggregate state taxable incomes can be compared with U.S. source taxable income on the federal income tax return in the manner described in Examples 25 and 26. In allocating P's deduction for state income taxes, it is necessary first to determine the portion, if any, of the deduction that is definitely related and allocable to a particular class of gross income. A definite relationship exists between a deduction for state income tax and dividend income when a state includes portfolio dividends in state taxable income apportionable to the taxpayer's activities in the state, but determines state taxable income by applying an apportionment formula that excludes the factors of the corporations paying portfolio dividends.

(B) In this case, $150,000 of foreign source portfolio dividends are subject to a state F apportionment fraction of 25 percent, which results in a total of $37,500 of state F taxable income attributable to such dividends. As illustrated in Example 28, $3,750 ($150,000 x 25 percent state F apportionment percentage x 10 percent state F tax rate) of P's state F income tax is definitely related and allocable to a class of gross income consisting entirely of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends paid by first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $3,750 of state F tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned.

(C) After reducing state F taxable income of the unitary business group by the taxable income attributable to portfolio dividends, P's remaining state F taxable income equals $462,500 ($500,000 - $37,500), the portion of the taxable income of the unitary business that state F attributes to P's activities in state F. Accordingly, in order to allocate and apportion the remaining $46,250 of state F tax ($50,000 of state F tax minus the $3,750 of state F tax allocated to foreign source portfolio dividends), it is necessary first to determine if state F is taxing only P's non-unitary taxable income (as defined below) or is imposing its tax partly on other unitary business income that is attributed under state F law to P's activities in state F. P's state F non-unitary taxable income is computed by applying the state F apportionment formula, solely on the basis of P's income (excluding portfolio dividends) and state F apportionment factors. If the state F taxable income (after reduction by the portfolio dividends attributed to state F) attributed to P under state F law exceeds P's non-unitary taxable income, a portion of the state F tax must be allocated and apportioned on the basis of the other unitary business income that is attributed to and taxable to P under state F law. If P's non-unitary taxable income equals or exceeds the $462,500 of remaining state F taxable income, it is presumed that state F is only taxing P's non-unitary taxable income, so that the entire amount of the remaining state F tax should be allocated and apportioned in the manner described in Example 25.

(D) If P's non-unitary taxable income is less than the $462,500 of remaining state F taxable income (after reduction for the $37,500 of state F taxable income attributable to portfolio dividends), it is presumed that state F is attributing to P, and taxing P upon, other unitary business income. In such a case, it is necessary to determine if state F is attributing to P, and imposing its income tax on, a part of the foreign source income that would be generally presumed under separate accounting to be the income of foreign affiliates and 80/20 companies included in the unitary group, or whether state F is limiting the income it attributes to P, and its taxation of P, to the U.S. source income that would be generally presumed under separate accounting to be the income of domestic members of the unitary group.

(E) Assume for purposes of this example that the non-unitary taxable income attributable to P equals $396,000, computed by multiplying P's state F taxable income of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) by P's non-unitary state F apportionment fraction, which is assumed to be 44 percent. Because P's non-unitary taxable income of $396,000 is less than the $462,500 of remaining state F taxable income, state F is presumed to be attributing to P and taxing the income that would have been generally attributed under separate accounting to P's affiliates in the unitary group. To determine if state F tax is being imposed on members of the unitary group (other than P) that produce foreign source income, it is necessary to compute a hypothetical state F taxable income for all companies in the unitary group with significant U.S. operations. (For this purpose, the hypothetical group of companies with significant domestic operations is referred to as the "water's edge group.") State F is presumed to be attributing to P and taxing income that would have been generally attributable under separate accounting to foreign corporations and 80/20 companies to the extent that the remaining state F taxable income ($462,500) of P exceeds the hypothetical state F taxable income that would have been attributed under state F law to P if state F had defined the unitary group to be the water's edge group.

(F) The members of the water's edge group would have been P and US1. The unitary business income of this water's edge group is $1,000,000, the sum of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) and $100,000 (US1's state F taxable income). For purposes of this example, the state F apportionment fraction determined on a unitary basis for this water's edge group is assumed to equal 40 percent, the average of P and US1's state F payroll, property, and sales factor ratios (the water's edge group's state F factors over its worldwide factors). Applying this apportionment fraction to the $1,000,000 of unitary business income of the water's edge group yields state F water's edge taxable income of $400,000. The excess of the remaining $462,500 of P's state F taxable income over the $400,000 of P's state F water's edge taxable income equals $62,500, and is attributable to the inclusion of US2 and FS in the unitary group. The state F tax attributable to the $62,500 of taxable income attributed to P under state F law, and that would have generally been attributed to US2 and FS under non-unitary accounting, equals $6,250 and is allocated entirely to a class of gross income consisting of foreign source general limitation income, because the income of FS and US2 consists entirely of such income. After the $6,250 of state F tax attributable to US2 and FS is subtracted from the remaining $46,250 of net state F tax, P has $40,000 of state F tax remaining to be allocated and apportioned.

(G) To the extent that the remainder of P's state F taxable income ($400,000) exceeds P's non-unitary state F taxable income ($396,000), it is presumed that state F is attributing to and imposing on P a tax on U.S. source income that would have been attributed under separate accounting to members of the water's edge group other than P. In these facts, the $4,000 difference in P's state F taxable income results from the inclusion of US1 in the unitary group. The $400 of P's state F tax attributable to this $4,000 is allocated entirely to P's U.S. source income. P's remaining $39,600 of state F tax ($40,000 of P's state F tax resulting from the attribution of P of income that would have been attributed under non-unitary accounting to other members of the water's edge group, minus $400 of state F tax attributable to US1 and allocated to P's U.S. source income) is the state F tax attributable to P's non-unitary state F taxable income that is to be allocated and apportioned together with P's state G tax of $15,000 and state H tax of $6,000 as illustrated in Example 25.

(H) In allocating the $60,600 of state tax liabilities ($39,600 state F tax attributable to P's non-unitary state F income + $15,000 state G tax + $6,000 state H tax) under Example 25, P's state taxable income in state G and state H ($300,000 + $300,000) must be added to P's non-unitary state F taxable income ($396,000). The resulting $996,000 of combined state taxable incomes is compared with $750,000 of U.S. source income on P's federal income tax return. Because P's combined state taxable incomes exceeds P's federal U.S. source taxable income, it is presumed that the remaining $60,600 of P's total state income taxes is imposed in part on foreign source income. Accordingly, P's remaining deduction of $60,600 ($39,600 + $15,000 + $6,000) for state income taxes is related and allocable to both P's foreign source and domestic source income and is subject to apportionment.

(iii) Apportionment.

The $60,600 of state taxes (the remaining $39,600 of state F tax + $15,000 of state G tax + $6,000 of state H tax) must be apportioned between foreign source general limitation income and U.S. source income for federal income tax purposes. This apportionment is based upon the relative amounts of foreign source general limitation taxable income and U.S. source taxable income comprising the $996,000 of income subject to tax by the states, after reducing the total amount of income subject to tax by the portfolio dividends and the income attributed to P under state F law that would have been attributed under arm's length principles to other members of P's state F unitary business group. The deduction for the $60,600 of state income taxes is apportioned as follows:

```
State income tax deduction apportioned
            to foreign source general limitation
            income (statutory grouping):
            $60,600 x ($246,000/$996,000)             $14,967
          State income tax deduction apportioned
            to income from sources within the United
            States (residual grouping):
            $60,600 x ($750,000/$996,000)              45,633
                                                     ---------
          Total apportioned state income tax
            deduction                                  60,600
```

Of the total state income taxes of $71,000, the amount allocated and apportioned to foreign source general limitation income is $24,967--the sum of $14,967 of state F, state G, and state H taxes apportioned to foreign source general limitation income, $3,750 of state F tax allocated to foreign source apportionable dividend income, and the $6,250 of state F tax allocated to foreign source general limitation income as the result of state F's worldwide unitary business theory of taxation. The total amount of state income taxes allocated and apportioned to U.S. source income equals $46,033--the sum of the $400 of state F tax attributable to the inclusion of US1 in the state F unitary business group and $45,633 of combined state F, G, and H tax apportioned under the method provided in Example 25.

Example 30--Income Taxes--

(i) Facts.

(A) As in Example 17 of section 1.861-8(g), X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign source taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign source loss of $50,000. O has gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike Example 17 of section 1.861-8(g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the "state apportionment fraction") that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(ii) Allocation and apportionment.

In accordance with section 1.1502-4, each corporation must first compute its separate taxable income for purposes of computing the consolidated limitation on the foreign tax credit. Assume that under Example 29, it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under Example 17, without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated foreign tax credit limitation.

Example 31--Income Taxes--

(i) Facts.

Assume that the facts are the same as in Example 29, except that state G requires P to adjust its federal taxable income by depreciating an asset at a different rate than is allowed P under the Internal Revenue Code for the same asset. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes its taxable income under state G law by using the rate of depreciation that it is entitled to use under the Code, and uses this recomputed amount in applying the methodology of Example 25.

(ii) Allocation.

P's modification of its state G taxable income is permissible. Under the methodology of Example 25, this modification of state G taxable income will produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign sources income.

Example 32--Income Taxes--

(i) Facts.

Assume the facts are the same as Example 29, except that P's state F taxable income differs from the amount of its U.S. source income under federal income tax principles solely because state F determines P's state taxable income under a worldwide unitary business theory instead of the arm's length principles applied in the Code. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes state F taxable income under the arm's length principles applied in the Code. P substitutes that recomputed amount for the amount of taxable income actually determined under state F law in applying the methodology of Example 25.

(ii) Allocation.

P's modification of state F taxable income does not accurately reflect the factual relationship between the deduction for state F income tax and the income on which the tax is imposed, because there is no factual relationship between the state F income tax and the state F taxable income as recomputed under Code principles. State F does not impose its income tax upon P's income as it might have been defined under the Internal Revenue Code. Consequently, P's modification of state F taxable income is impermissible because it will not produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign source income.

Example 33--Income Taxes--

(i) Facts.

Assume the same facts as in Example 29, except that state G does not impose an income tax on corporations, and P's non-unitary state F taxable income equals $462,500. Thus only $56,000 of state income taxes ($50,000 of state F income tax and $6,000 of state H income tax) are deductible and required to be allocated and (if necessary) apportioned. As in Example 29, P has $800,000 of aggregate state taxable income ($500,000 of state F taxable income and $300,000 of state H taxable income).

(ii) Method One.

Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in section 1.861-8 (e)(6)(ii)(D)(2) ("Method One").

(A) Step One--Specific allocation to foreign source portfolio dividends.

P applies the methodology of paragraph (ii) of Example 28 to determine the portion of the deduction that must be allocated to a class of gross income consisting solely of foreign source portfolio dividends. As illustrated in paragraphs (ii) (A) and (B) of Example 29, $3,750 of the deduction for state F income tax is attributable to the $37,500 of foreign source portfolio dividends attributed under state F law to P's activities in state F. Thus $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends). Because the remaining amount of state F taxable income ($462,500) equals P's non-unitary state F taxable income, no further specific allocation of state tax is required.

(B) Step Two--Adjustment of U.S. source federal taxable income.

P applies the methodology illustrated in paragraph (ii) of Example 27 (including the rules of UDITPA described therein) to determine the amount of its federal taxable income attributable to its activities in state G. Assume that P determines under this methodology that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) Step Three--Allocation.

The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(2)(iii) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with an amount equal to 110% of its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds 110% of P's adjusted U.S. source federal taxable income ($495,000, or 110% of $450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) Step Four--Apportionment.

P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to 110% of P's adjusted U.S. source federal taxable income. The remainder of the deduction must be apportioned to foreign source general limitation income.

```
Amount of deduction to be apportioned        $52,250.00
```

```
Less portion of deduction to be
  apportioned to income from sources
  within the United States (residual
  grouping):
  ($52,250 x ($495,000/$762,500)            $33,919.67
                                           ------------
Equals Portion of deduction to be
  apportioned to foreign source general
  limitation income (statutory grouping):   $18,330.33
```

(iii) Method Two.

Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in section 1.861-8(e)(6)(ii)(D)(3) ("Method Two").

(A) Step One--Specific allocation.

Step One of Method Two is the same as Step One of Method One. Therefore, as described in paragraph (A) of paragraph (ii) above, $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends).

(B) Step Two--Adjustment of U.S. source federal taxable income.

Step Two of Method Two is the same as Step Two of Method One. Therefore, as described in paragraph (B) of paragraph (ii) above, assume that P determines that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) Step Three--Allocation.

The portion of P's deduction for state income tax remaining to be allocated equals $52,250

($56,000 minus the $3,750 of state F income tax specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(3)(iii) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds P's adjusted U.S. source federal taxable income ($450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) Step Four--Apportionment.

P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to P's adjusted U.S. source federal taxable income.

```
Amount of deduction to be apportioned        $52,250.00

Less portion of deduction initially

  apportioned to income from sources

  within the United States (residual

  grouping):

  $52,250  x  ($450,000/$762,500)             30,836.07

                                             -----------

Remainder requiring further

  apportionment: $52,250  x

  ($312,500/$762,500)                         21,413.93
```

The remainder of $21,413.93 must be further apportioned between foreign source general limitation income and U.S. source federal taxable income in the same proportions that P's adjusted U.S. source federal taxable income and foreign source general limitation income bear to P's total federal taxable income (taking into account the adjustment of U.S. source federal taxable income) and reduced by the amount of foreign source portfolio dividends to which the tax has been specifically allocated.

```
     Portion of remainder apportioned to
                    foreign source general limitation
                    income (statutory grouping):
                    $21,413.93 x ($212,500/$662,500)            $6,868.62
                  Remaining state income tax deduction
                    to be apportioned to income from
                    sources within the United States
                    (residual grouping):
                    $21,413.93  x  ($450,000/$662,500)          14,545.31
```

Of P's total deduction of $56,000 for state income tax, the portion allocated and apportioned to foreign source general limitation income equals $10,618.62--the sum of $6,868.62 apportioned under Step Four and the $3,750.00 specifically allocated to foreign source portfolio dividend income under Step One. The portion of the deduction allocated and apportioned to U.S. source income equals $45,381.38--the sum of the $30,836.07 and the $14,545.31 apportioned under Step Four.

(Secs. 882(c) and 7805 of the Internal Revenue Code of 1954 (80 Stat. 1556; 26 U.S.C. 882(c) and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7456, 42 FR 1195, Jan. 6, 1977, as amended by T.D. 7749, 46 FR 1683, Jan. 7, 1981; T.D. 7939, 49 FR 4207, Feb. 3, 1984; T.D. 8228, 53 FR 35474, Sept. 14, 1988; T.D. 8286, 55 FR 3052, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; corrected by 60 FR 36669, July 18, 1995; T.D. 8646, 60 FR 66502-66510, Dec. 22, 1995; T.D. 8805, Federal Register: January 11, 1999 (Volume 64, Number 6)] [Page 1505-1516]

Code **Sec. 1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (Temporary).**

(a) In general.

(1) [Reserved]

(2) Allocation and apportionment of deductions in general.

If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See section 1.861-9T through section 1.861-11T for rules regarding the affiliated group allocation and apportionment of interest expense, and section 1.861-14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(3)--(5) [Reserved]

(b) Allocation.

(1) and (2) [Reserved]

(3) Supportive functions.

Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could be reasonably expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples (19) through (21) of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities. However, supportive deductions that are described in section 1.861-14T(e)(3) shall be allocated and apportioned in accordance with the rules of section 1.1861-14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in section 1.861-14T(d).

(4) and (5) [Reserved]

(c) Apportionment of deductions.

(1) Deductions definitely related to a class of gross income.

Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to--

(i) Comparison of units sold,

(ii) Comparison of the amount of gross sales or receipts,

(iii) Comparison of costs of goods sold,

(iv) Comparison of profit contribution,

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and

(iv) Comparison of the amount of gross income.

Paragraph (e) (2) through (8) of this section provides the applicable rules for allocation and apportionment of deductions for interest, research and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Furthermore, certain methods of apportionment described in this paragraph (c)(1) may not be used in connection with any deduction for which another method is prescribed. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section.

(2) Apportionment based on assets.

Certain taxpayers are required by paragraph (e)(2) of this section and section 1.861-9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that such method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of section 1.861-9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or on their fair market value. However, once the taxpayer uses fair market value, the taxpayer and all related persons must continue to use such method unless expressly authorized by the

Commissioner to change methods. For purposes of this paragraph (c)(2) the term "related persons" means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned by the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3). In the case of any corporate taxpayer that--

(i) Uses tax book value, and

(ii) Owns directly or indirectly (within the meaning of section 1.861-11T(b)(2)(ii)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), such taxpayer shall adjust its basis in that stock in the manner described in section 1.861-11T(b).

(3) [Reserved]

(d) Excess of deductions and excluded and eliminated items of income.

(1) [Reserved]

(2) Allocation and apportionment to exempt, excluded or eliminated income.

(i) In general.

In the case of taxable years beginning after December 31, 1986, except to the extent otherwise permitted by section 1.861-13T, the following rules shall apply to take account of income that is exempt or excluded, or assets generating such income, with respect to allocation and apportionment of deductions.

(A) Allocation of deductions.

In allocating deductions that are definitely related to one or more classes of gross income, exempt income (as defined in paragraph (d)(2)(ii) of this section) shall be taken into account.

(B) Apportionment of deductions.

In apportioning deductions that are definitely related either to a class of gross income consisting of multiple groupings of income (whether statutory or residual) or to all gross income, exempt income and exempt assets (as defined in paragraph (d)(2)(ii) of this section) shall not be taken into account.

For purposes of apportioning deductions which are not taken into account under section 1.1502-13 in determining gain or loss from intercompany transactions, as defined in section 1.1502-13, income from such transactions shall be taken into account in the year such income is ultimately included in gross income.

(ii) Exempt income and exempt assets defined--

(A) In general.

For purposes of this section, the term "exempt income" means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term "exempt asset" means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) Certain stock and dividends.

The term "exempt income" includes the portion of the dividends that are deductible under--

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

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

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

(iii) Income that is not considered tax exempt.

The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

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

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

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

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

(iv) Prior years.

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

(e) Allocation and apportionment of certain deductions.

(1) [Reserved]

(2) Interest.

The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in sections 1.861-9T through 1.861-13T.

(3)--(7) [Reserved]

(8) Net operating loss deduction.

A net operating loss deduction allowed under section 172 shall be allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction.

(9)--(11) [Reserved]

(f) Miscellaneous matters.

(1) Operative sections.

(i) [Reserved]

(ii) Separate limitations to the foreign tax credit.

Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual groups.

(f) (1)(iii)--(5) [Reserved]

(g) [Reserved]

Examples (1)--(23). [Reserved]

Example (24)--Exempt, excluded, or eliminated income--

(i) Income method--

(A) Facts.

X, a domestic corporation organized on January 1, 1987, is engaged in a number of businesses worldwide. X owns a 25-percent voting interest in each of five corporations engaged in the business A, two of which are domestic and three of which are foreign. X incurs stewardship expenses in connection with these five stock investments in the amount of $100. X apportions its stewardship expenses using a gross income method. Each of the five companies pays a dividend in the amount of $100. X is entitled to claim the 80-percent dividends received deduction on dividends paid by the two domestic companies. Because tax exempt income is considered in the allocation of deductions, X's $100 stewardship expense is allocated to the class of income consisting of dividends from business A companies. However, because tax exempt income is not considered in the apportionment of deductions within a class of gross income, the gross income of the two domestic companies must be reduced to reflect the availability of the dividends received deduction. Thus, for purposes of apportionment, the gross income paid by the three foreign companies is considered to be $100 each, while the gross income paid by the domestic companies is considered to be $20 each. Accordingly, X has total gross income from business A companies, for purposes of apportionment, of $340. As a result, $29.41 of X's stewardship expense is apportioned to each of the foreign companies and $5.88 of X's stewardship expense is apportioned to each of the domestic companies.

(ii) Asset method--

(A) Facts.

X, a domestic corporation organized on January 1, 1987, carries on a trade or business in the United States. X has deductible interest expense incurred in 1987 of $60,000. X owns all the stock of Y, a foreign corporation. X also owns 49 percent of the voting stock of Z, a domestic corporation. Neither Y nor Z has retained earnings and profits at the end of 1987. X apportions its interest expense on the basis of the fair market value of its assets. X has assets worth $1,500,000 that generate domestic source income, among which are tax exempt municipal bonds worth $100,000, and the stock of Z, which has a value of $500,000. The Y stock owned by X has a fair market value of $2,000,000 and generates solely foreign source general limitation income.

(B) Allocation.

No portion of X's interest expense is directly allocable solely to identified property within the meaning of section 1.861-1OT. Thus, X's deduction for interest is definitely related to all its gross income as a class.

(C) Apportionment.

For purposes of apportioning expenses, assets that generate exempt, eliminated, or excluded income are not taken into account. Because X's municipal bonds are tax exempt, they are not taken into account in apportioning interest expense. Since X is entitled to claim under section 243 to 80-percent dividends received deduction with respect to the dividend it received from Z, 80 percent of the value of that stock is not taken into account as an asset for purposes of apportionment under the asset method. X apportions its interest deduction between the statutory grouping of foreign source general limitation income and the residual grouping of domestic source income as follows:

```
To foreign source general limitation income:

                                General limitation assets

                                that are not tax exempt

Interest  expense      X    ------------------------------

                              Worldwide assets that are not

                                      tax exempt

                                     $2,000,000

    $60,000   X    ---------------------------------------    =  $40,000

                     ($100,000 + $900,000 + $2,000,000)

                        Nonexempt foreign assets

       ----------------------------------------------------------

        20                      Nonexempt                  Nonexempt

      percent       +           domestic        +           foreign

    of Z stock                   assets                      assets

       value

To domestic source income:

                        Domestic assets that are not tax exempt
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Interest expense X ---------------------------------------------------

                        Worldwide assets that are not tax exempt

                                     $100,000+$900,000

 $60,000   X    ---------------------------------------------------  =  $20,000

                            ($100,000 + $900,000 + $2,000,000)

               20 percent of Z stock value + nonexempt domestic assets

--------------------------------------------------------------------------------

           20                   Nonexempt                      Nonexempt

         percent      +         domestic           +            foreign

       of  Z stock               assets                          assets

          value
```

(h) Effective dates.

In general, the rules of this section, as well as the rules of sections 1.861-9T, 1.861-10T, 1.861-11T, 1.861-12T, and 1.861-14T shall apply for taxable years beginning after December 31, 1986. In the case of corporate taxpayers, transition rules set forth in section 1.861-13T provide for the gradual phase-in of certain the provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(1) Section 1.861-9T(b)(2) (concerning the treatment of certain foreign currency borrowings),

(2) Section 1.861-9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens),

(3) Section 1.861-10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception), and

(4) Section 1.861-10T(b)(6) (concerning excess collateralization of nonrecourse borrowings).

In addition, section 1.861-10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is effective for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by section 1.861-13T, see section 1.861-8 (Revised as of April 1, 1986). Paragraph (e)(8) of this section shall cease to be effective January 8, 2002.

[T.D. 8228, 53 FR 35474, Sept. 14, 1988, as amended by T.D. 8286, 55 FR 3054, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; T.D. 8597, 60 FR 3661-36710, July 18, 1995; T.D. 8805, Federal Register: January 11, 1999 (Volume 64, Number 6)] [Page 1505-1516]

Code **Sec. 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.**

(a) In general.

(1) Scope.

Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities under other sections of the Code, referred to in this section as operative sections. See paragraph (f)(1) of this section for a list and description of operative sections. The operative sections include, among others, sections 871(b) and 882 (relating to taxable income of a nonresident alien individual or a foreign corporation which is effectively connected with the conduct of a trade or business in the United States), section 904(a)(1) (as in effect before enactment of the Tax Reform Act of 1976, relating to taxable income from sources within specific foreign countries), and section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment, relating to taxable income from all sources without the United States).

(2) Allocation and apportionment of deductions in general.

A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except the deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

(3) Class of gross income.

For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61, namely:

(i) Compensation for services, including fees, commissions, and similar items;

(ii) Gross income derived from business;

(iii) Gains derived from dealings in property;

(iv) Interest;

(v) Rents;

(vi) Royalties;

(vii) Dividends;

(viii) Alimony and separate maintenance payments;

(ix) Annuities;

(x) Income from life insurance and endowment contracts;

(xi) Pensions;

(xii) Income from discharge of indebtedness;

(xiii) Distributive share of partnership gross income;

(xiv) Income in respect of a decedent;

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

(4) Statutory grouping of gross income and residual grouping of gross income.

For purposes of this section, the term "statutory grouping of gross income" or "statutory grouping" means the gross income from a specific source or activity which must first be determined in order to arrive at "taxable income" from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the "residual grouping of gross income" or "residual grouping." For example, for purposes of determining taxable income from sources within specific foreign countries and possessions of the United States, in order to apply the per-country limitation to the foreign tax credit (as in effect before enactment of the Tax Reform Act of 1976), the statutory groupings are the separate gross incomes from sources within each country and possession. Moreover, if the taxpayer has income subject to section 904(d) (as in effect after enactment of the Tax Reform Act of 1976), such income constitutes one or more separate statutory groupings. In the case of the per-country limitation, the residual grouping is the aggregate of gross income from sources within the United States. In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. See paragraph (d)(2) of this section with respect to the allocation and apportionment of deductions to excluded income.

(5) Effective date.

(i) Taxable years beginning after December 31, 1976.

The provisions of this section apply to taxable years beginning after December 31, 1976.

(ii) Taxable years beginning before January 1, 1977.

For taxable years beginning before January 1, 1977, section 1.861-8 applies as in effect on October 23, 1957 (T.D. 6258), as amended on August 22, 1966 (T.D. 6892) and on September 29, 1975 (T.D. 7378). The specific rules for allocation and apportionment of deductions set forth in this section may, at the option of the taxpayer, apply to those taxable years on a deduction-by-deduction basis if the rules are applied consistently to all taxable years with respect to which action by the Internal Revenue Service is not barred by any statute of limitations. Thus, for example, a calendar year taxpayer may choose to have the rules of paragraph (e)(2) of this section apply for the allocation and apportionment of all interest expenses for the two taxable years ending December 31, 1975 and 1976, which are open years under examination, and may justify the allocation and apportionment of all research and development expenses for those years on a basis supportable under section 1.861-8 as in effect for 1975 and 1976 without regard to the rules of paragraph (e)(3) of this section.

(b) Allocation.

(1) In general.

For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. See paragraph (d)(1) of this section which provides that in a taxable year there may be no item of gross income in a class or less gross income than deductions allocated to the class, and paragraph (d)(2) of this section which provides that a class of gross income may include excluded income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxpayable year in which such gross income is received or accrued or is expected to be received or accrued). The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. (See paragraph (e)(9) of this section.) In allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.

(2) Relationship to activity or property.

A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. See paragraph (d)(1) of this section and example (17) of paragraph (g) of this section with respect to cases in which there is an excess of deductions. In some cases, it will be found that this subparagraph can most readily be applied by determining, with respect to a deduction, the categories of gross income to which it is not related and concluding that it is definitely related to a class consisting of all other gross income.

(3) Supportive functions.[Reserved]

For guidance, see section 1.861-8T(b)(3).

(4) Deductions related to a class of gross income.

See paragraph (e) of this section for rules relating to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) of this section for rules relating to the apportionment of deductions.

(5) Deductions related to all gross income.

If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, it shall ordinarily be treated as definitely related and allocable to all of the taxpayer's gross income except where provided to the contrary under paragraph (e) of this section. Paragraph (e)(9) of this section lists various deductions which generally are not definitely related to any gross income and are ratably apportioned to all gross income.

(c) Apportionment of deductions.

(1) Deductions definitely related to a class of gross income.

[Reserved] For guidance, see section 1.861-8T(c)(1).

(2) Apportionment based on assets.

[Reserved] For guidance, see section 1.861-8T(c)(2).

(3) Deductions not definitely related to any gross income.

If a deduction is not definitely related to any gross income (see paragraph (e)(9) of this section), the deduction must be apportioned ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping. Thus, the amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income.

(d) Excess of deductions and excluded and eliminated income.

(1) Excess of deductions.

Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section even though, for the taxable year, no gross income in such class is received or accrued or the amount of the deduction exceeds the amount of such class of gross income. In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping). If there is no gross income in a statutory grouping or the amount of deductions allocated and apportioned to a statutory grouping exceeds the amount of gross income in the statutory grouping, the effects are determined under the operative section. If the taxpayer is a member of a group filing a consolidated return, such excess of deductions allocated or apportioned to a statutory grouping of income of such member is taken into account in determining the consolidated taxable income from such statutory grouping, and such excess of deductions allocated or apportioned to the residual grouping of income is taken into account in determining the consolidated taxable income from the residual grouping. See section 1.1502-4(d)(1) and the last sentence of section 1.1502-12. For an illustration of the principles of this paragraph (d)(1), see example (17) of paragraph (g) of this section.

(2) Allocation and apportionment to exempt, excluded, or eliminated income.

[Reserved] For guidance, see section 1.861-8T(d)(2).

(e) Allocation and apportionment of certain deductions.

(1) In general.

Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Subparagraphs (4) through (8) of this paragraph contain rules with respect to the allocation of certain other deductions. Subparagraph (9) of this paragraph lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Subparagraph (10) of this paragraph lists special deductions of corporations which must be allocated and apportioned. Subparagraph (11) of this paragraph lists personal exemptions which are neither allocated nor apportioned. Examples of allocation and apportionment are contained in paragraph (g) of this section.

(2) Interest.

[Reserved] For guidance, see section 1.861-8T(e)(2).

(3) Research and experimental expenditures.

For rules regarding the allocation and apportionment of research and experimental expenditures, see section 1.861-17.

(4) Stewardship expenses attributable to dividends received.

If a corporation renders services for the benefit of a related corporation and the corporation charges the related corporation for such services (see section 482 and the regulations thereunder which provide for an allocation where the charge is not on an arm's length basis as determined therein), the deductions for expenses of the corporation attributable to the rendering of such services are considered definitely related to the amounts so charged and are to be allocated to such amounts. However, the regulations under section 482 (section 1.482-2(b)(2)(ii) recognize a type of activity which is not considered to be for the benefit of a related corporation but is considered to constitute "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in the related corporation, and therefore, a charge to the related corporation for such stewardship or overseeing functions is not provided for. Services undertaken by a corporation of a stewardship or overseeing character generally represent a duplication of services which the related corporation has independently performed for itself. For example, assume that a related corporation, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs and submits a report of its findings and a plan of borrowing to the parent corporation, and the parent corporation's financial staff reviews the findings and plans to determine whether to advise the related corporation to reconsider its plan. The services of review performed by the parent corporation for its own benefit are of a stewardship or overseeing character. The deductions resulting from stewardship or overseeing functions are incurred as a result of, or incident to, the ownership of the related corporation and, thus, shall be considered definitely related and allocable to dividends received or to be received from the related corporation. If a corporation has a foreign or international department which exercises stewardship or overseeing functions with respect to related foreign corporations and, in addition, the department has other functions which are attributable to other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign royalties, and gross income of foreign branches) to which its deductions are also to be allocated, some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also be attributable to United States source income (such as fees for services performed in the United States) to which its deductions are to be allocated. Methods of apportionment which could possibly be utilized with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See examples (17) and (18) of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship activities.

(5) Legal and accounting fees and expenses.

Fees and other expenses for legal and accounting services are ordinarily definitely related and allocable to specific classes of gross income or to all the taxpayer's gross income, depending on the nature of the services rendered (and are apportioned as provided in paragraph (c)(1) of this section). For example, accounting fees for the preparation of a study of the costs involved in manufacturing a specific product will ordinarily be definitely related to the class of gross income derived from (or which could reasonably have been expected to be derived from) that specific product. The taxpayer is not relieved from his responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as "professional," or does not provide any type of allocation, or does not properly allocate the fees involved.

(6) Income taxes.

(i) In general.

The deduction for state, local, and foreign income, war profits and excess profits taxes ("state income taxes") allowed by section 164 shall be considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. For example, if a domestic corporation is subject to state income taxation and the state income tax is imposed in part on an amount of foreign source income, then that part of the taxpayer's deduction for state income tax that is attributable to foreign source income is definitely related and allocable to foreign source income. In allocating and apportioning the deduction for state income tax for purposes including (but not limited to) the computation of the foreign tax credit limitation under section 904 of the Code and the consolidated foreign tax credit under section 1.1502-4 of the regulations, the income upon which the state income tax is imposed is determined by reference to the law of the jurisdiction imposing the tax. Thus, if a state attributes taxable income to a corporate taxpayer by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the corporate taxpayer and engaging in activities related to the business of the corporate taxpayer, then the income so attributed is the income upon which the state income tax is imposed. If the income so attributed to the corporate taxpayer includes foreign source income, then, in computing the taxpayer's foreign tax credit limitation under section 904, for example, the taxpayer's deduction for state income tax will be considered definitely related and allocable to a class of gross income that includes the statutory grouping of foreign source income. When the law of the state includes dividends that are treated under section 862(a)(2) as income from sources without the United States in taxable income apportionable to the state, but does not include factors of the corporation paying such dividends in the apportionment formula used to determine state taxable income, an appropriate portion of the deduction for state income tax will be considered definitely related and allocable to a class of gross income consisting solely of foreign source dividend income. A deduction for state income tax will not be considered definitely related to a hypothetical amount of income calculated under federal tax principles when the jurisdiction imposing the tax computes taxable income under different principles. A corporate taxpayer's deduction for a state franchise tax that is computed on the basis of income attributable to business activities conducted within the state must be allocated and apportioned in the same manner as the deduction for state income taxes. In determining, for example, both the foreign tax credit under section 904 of the Code and the consolidated foreign tax credit limitation under section 1.1502-4 of the regulations, the deduction for state income tax may be allocable and apportionable to foreign source income in a statutory grouping described in section 904(d) in a taxable year in which the taxpayer has no foreign source income in such statutory grouping. Alternatively, such an allocation or apportionment may be appropriate if a taxpayer corporation has no foreign source income in a statutory grouping, but its deduction is attributable to foreign source income in such grouping that is attributed to the taxpayer corporation under the law of a state which attributes taxable income to a corporation by applying an apportionment formula that takes into consideration the income and factors of one or more corporations related by ownership to the taxpayer corporation and engaging in activities related to the business of the taxpayer corporation. Example 30 of paragraph (g) of this section illustrates the application of this last rule.

(ii) Methods of allocation and apportionment.

(A) In general.

A taxpayer's deduction for a state income tax is to be allocated (and then apportioned, if necessary, subject to the rules of section 1.861-8(d)) by reference to the taxable income that the law of the taxing jurisdiction attributes to the taxpayer ("state taxable income").

(B) Effect of subsequent recomputations of state income tax. [Reserved]

(C) Illustrations.

(1) In general.

Examples 25 through 32 of paragraph (g) of section 1.861-8 illustrate, in the given factual situations, the application of this paragraph (e)(6) and the general rule of paragraph (b)(1) of this section that a deduction must be allocated to the class of gross income to which the deduction is factually related. In general, these examples employ a presumption that state income taxes are allocable to a class of gross income that includes the statutory grouping of income from sources without the United States when the total amount of taxable income determined under state law exceeds the amount of taxable income determined under the Code (without taking into account the deduction for state income taxes) in the residual grouping of income from sources within the United States. A taxpayer that allocates and apportions the deduction for state income tax in accordance with the methodology of Example 25 of paragraph (g) of this section must also apply the modifications illustrated in Examples 26 and 27 of paragraph (g) of this section, when applicable. The modification illustrated in Example 26 is applicable when the deduction for state income tax is attributable in part to taxes imposed by a state which factually excludes foreign source income (as determined for federal income tax purposes) from state taxable income. The modification illustrated in Example 27 is applicable when the taxpayer has income-producing activities in a state which does not impose a corporate income tax. The specific allocation of state income tax illustrated in Example 28 follows the rule in paragraph (e)(6)(i) of this section, and must be applied whenever a taxpayer's state taxable income includes dividends apportioned to the state under a formula that does not take into account the factors of the corporations paying those dividends, regardless of whether the taxpayer uses the methodology of Example 25 with respect to the remainder of the deduction for state income taxes.

(2) Modifications.

Before applying a method of allocation and apportionment illustrated in the examples, the computation of state taxable income under state law may be modified, subject to the approval of the District Director, to reflect more accurately the income with respect to which the state income tax is imposed. Any modification to the state law computation of state taxable income must yield an allocation and apportionment of the deduction for state income taxes that is consistent with the rules contained in this paragraph (e)(6), and that accurately reflects the factual relationship between the state income tax and the income on which that tax is imposed. For example, a modification to the computation of taxable income under state law might be appropriate to compensate for differences between the state law definition of taxable income and the federal definition of taxable income, due to a difference in the rate of allowable depreciation or the amount of another deduction that is allowable under both systems. This rule is illustrated in Example 31 of paragraph (g) of this section. However, a modification to the computation of taxable income under state law will not be appropriate, and will not more accurately reflect the factual relationship between the state tax and the income on which the tax is imposed, to the extent such modification reflects the fact that the state does not follow federal tax principles in attributing income to the taxpayer's activities in the state. This rule is illustrated in Example 32 of paragraph (g) of this section. A taxpayer may not modify the methods illustrated in the examples, or use an alternative method of allocation and apportionment of the deduction for state income taxes, if the modification or alternative method would be inconsistent with the rules of paragraph (e)(6)(i) of this section. A taxpayer that uses a method of allocation and apportionment other than one illustrated in Example 25 (as modified by Examples 26 and 27), or 29 with respect to a factual situation similar to those of the examples, must describe the alternative method on an attachment to its federal income tax return and establish to the satisfaction of the District Director, upon examination, that the result of the alternative method more accurately reflects the factual relationship between the state income tax and the income on which the tax is imposed.

(D) Elective safe harbor methods.

(1) In general.

In lieu of applying the rules set forth in paragraphs (e)(6)(ii) (A) through (C) of this section, a taxpayer may elect to allocate and apportion the deduction for state income tax in accordance with one of the two safe harbor methods described in paragraph (e)(6)(ii)(D) (2) and (3) of this section. A taxpayer shall make this election for a taxable year by filing a timely tax return for that year that reflects an allocation and apportionment of the deduction for state income tax under one of the safe harbor methods and attaching to such return a statement that the taxpayer has elected to use the safe harbor method provided in either paragraph (e)(6)(ii)(D) (2) or (3) of this section, as appropriate. Once made, this election is effective for the taxable year for which made and all subsequent taxable years, and may be revoked only with the consent of the Commissioner. Example 33 of paragraph (g) of this section illustrates the application of these safe harbor methods.

(2) Method One.

(i) Step One--Specific allocation to foreign source portfolio dividends and other income.

If any portion of the deduction for state income tax is attributable to tax imposed by a state which includes in a corporate taxpayer's taxable income apportionable to the state, portfolio dividends (as defined in paragraph (i) of Example 28 of paragraph (g) of this section) that are treated under section 862(a)(2) as income from sources without the United States, but does not include factors of the corporations paying the portfolio dividends in the apportionment formula used to determine state taxable income, the taxpayer shall allocate an appropriate portion of the deduction to a class of gross income consisting solely of foreign source portfolio dividends. The portion of the deduction so allocated, and the amount of foreign source portfolio dividends included in such class, shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 28 of paragraph (g). If a state income tax is determined based upon formulary apportionment of the total taxable income attributable to the taxpayer's unitary business, the taxpayer must also apply the methodology illustrated in paragraph (ii)(C) through (G) of Example 29 of paragraph (g) of this section to make specific allocations of appropriate portions of the deduction for state income tax on the basis of income that, under separate accounting, would have been attributed to other members of the unitary group. The taxpayer shall reduce its aggregate state taxable income by the amount of foreign source portfolio dividends to which a specific allocation is made (the reduced amount being referred to hereinafter as "adjusted state taxable income").

(ii) Step Two--Adjustment of U.S. source federal taxable income.

If the taxpayer has significant income-producing activities in a state which does not impose a corporate income tax or other state tax measured by income derived from business activities in the state, the taxpayer shall reduce its U.S. source federal taxable income (solely for purposes of this safe harbor method) by the amount of federal taxable income attributable to its activities in such state. This amount shall be determined in accordance with the methodology illustrated in paragraph (ii) of Example 27 of paragraph (g) of this section, provided that the taxpayer shall be required to use the rules of the Uniform Division of Income for Tax Purposes Act to attribute income to the relevant state. The taxpayer's U.S. source federal taxable income, as so reduced, is referred to hereinafter as "adjusted U.S. source federal taxable income."

(iii) Step Three--Allocation.

The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to an amount equal to 110% of its adjusted U.S. source federal taxable income.

(iv) Step Four--Apportionment.

In the event that apportionment of the remainder of the deduction for state income tax is required, the taxpayer shall apportion that remaining deduction to U.S. source income in accordance with the methodology illustrated in paragraph (iii) of Example 25 of paragraph (g) of this section, substituting for domestic source income in that paragraph an amount equal to 110% of the taxpayer's adjusted U.S. source federal taxable income. The remaining portion of the deduction shall be apportioned to the statutory groupings of foreign source income described in section 904(d) of the Code in accordance with the proportion of the income in each statutory grouping of foreign source income described in section 904(d) to the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above).

(3) Method Two.

(i) Step One--Specific allocation to foreign source portfolio dividends and other income.

Step One of this method is the same as Step One of Method One (as described in paragraph (e)(6)(ii)(D)(2)(i) of this section).

(ii) Step Two--Adjustment of U.S. source federal taxable income.

Step Two of this method is the same as Step Two of Method One (as described in paragraph (e)(6)(ii)(D)(2)(ii) of this section).

(iii) Step Three--Allocation.

The taxpayer shall allocate the remainder of the deduction for state income tax (after reduction by the portion allocated to foreign source portfolio dividends and other income under Step One) in accordance with the methodology illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section. However, the taxpayer shall substitute for the comparison of aggregate state taxable income to U.S. source federal taxable income, illustrated in paragraph (ii) of Example 25 of paragraph (g) of this section, a comparison of its adjusted state taxable income to its adjusted U.S. source federal taxable income.

(iv) Step Four--Apportionment.

In the event that apportionment of the deduction is required, the taxpayer shall apportion to U.S. source income that portion of the deduction that is attributable to state income taxes imposed upon an amount of state taxable income equal to adjusted U.S. source federal taxable income. The taxpayer shall apportion the remaining amount of the deduction to U.S. and foreign source income in the same proportions that the taxpayer's adjusted U.S. source federal taxable income and foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) bear to its total federal taxable income (taking into account the adjustment of U.S. source federal taxable income under Step Two and after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One). The portion of the deduction apportioned to foreign source income shall be apportioned among the statutory groupings described in section 904(d) of the Code in accordance with the proportions of the taxpayer's total foreign source federal taxable income (after reduction by the amount of foreign source portfolio dividends to which tax has been specifically allocated under Step One, above) in each grouping.

(iii) Effective dates.

The rules of section 1.861-8(e)(6)(i) and the language preceding the examples in section 1.861-8(g) are effective for taxable years beginning after December 31, 1976. The rules of section 1.861-8(e)(6)(ii) (other than section 1.861-8(e)(6)(ii)(D)) and Examples 25 through 32 of section 1.861-8(g) are effective for taxable years beginning on or after January 1, 1988. The rules of section 1.861-8(e)(6)(ii)(D) and Example 33 of section 1.861-8(g) are effective for taxable years ending after March 12, 1991. At the option of the taxpayer, however, the rules of section 1.861-8(e)(6)(ii) (other than section 1.861-8(e)(6)(ii)(D)) and Examples 25 through 32 of section 1.861-8(g) may be applied with respect to deductions for state taxes incurred in taxable years beginning before January 1, 1988.

(7) Losses on the sale, exchange, or other disposition of property.

(i) Allocation.

The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income to which such asset or property ordinarily gives rise in the hands of the taxpayer. Where the nature of gross income generated from the asset or property has varied significantly over several taxable years of the taxpayer, such class of gross income shall generally be determined by reference to gross income generated from the asset or property during the taxable year or years immediately preceding the sale, exchange, or other disposition of such asset or property. Thus, for example, where an asset generates primarily sales income from domestic sources in the early years of its operation and then is leased by the taxpayer to a foreign subsidiary in later years, the class of gross income to which the asset gives rise will be considered to be the rental income derived from the lease and will not include sales income from domestic sources.

(ii) Apportionment of losses.

Where in the unusual circumstances that an apportionment of a deduction for losses on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) is necessary, the amount of such deduction shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income (within the class of gross income) and the residual grouping (within the class of gross income) in the same proportion that the amount of gross income within such statutory grouping (or statutory groupings) and such residual grouping bear, respectively, to the total amount of gross income within the class of gross income. Apportionment will be necessary where, for example, the class of gross income to which the deduction is allocated consists of gross income (such as royalties) attributable to an intangible asset used both within and without the United States, or gross income (such as from sales or services) attributable to a tangible asset used both within and without the United States.

(iii) Allocation of loss recognized in taxable years after 1986.

See Secs. 1.865-1T, 1.865-2, and 1.865-2T for rules regarding the allocation of certain loss recognized in taxable years beginning after December 31, 1986.

(8) Net operating loss deduction. [Reserved.]

For guidance, see Sec. 1.861-8T(e)(8).

(9) Deductions which are not definitely related.

Deductions which shall generally be considered as not definitely related to any gross income, and therefore are ratably apportioned as provided in paragraph (c)(2) of this section, are--

(i) The deduction allowed by section 163 for interest described in subparagraph (2)(iii) of this paragraph (e);

(ii) The deduction allowed by section 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;

(iii) The deduction for medical expenses allowed by section 213;

(iv) The deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B); and

(v) The deduction for alimony payments allowed by section 215.

(10) Special deductions.

The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be allocated and apportioned consistent with the principles of this section.

(11) Personal exemptions.

The deductions for the personal exemptions allowed by section 151, 642(b), or 873(b)(3) shall not be taken into account for purpose of allocation and apportionment under this section.

(f) Miscellaneous matters.

(1) Operative sections.

The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below.

(i) Overall limitation to the foreign tax credit.

Under the overall limitation to the foreign tax credit, as provided in section 904(a)(2) (as in effect before enactment of the Tax Reform Act of 1976, or section 904(a) after such enactment) the amount of the foreign tax credit may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Accordingly, in this case, the statutory grouping is foreign source income (including, for example, interest received from a domestic corporation which meets the tests of section 861(a)(1)(B), dividends received from a domestic corporation which has an election in effect under section 936, and other types of income specified in section 862). Pursuant to sections 862(b) and 863(a) and sections 1.862-1 and 1.863-1, this section provides rules for identifying the deductions to be taken into account in determining taxable income from sources without the United States. See section 904(d) (as in effect after enactment of the Tax Reform Act of 1976) and the regulations thereunder which require separate treatment of certain types of income. See example (3) of paragraph (g) of this section for one example of the application of this section to the overall limitation.

(ii)[Reserved]

(iii) DISC and FSC taxable income.

Sections 925 and 994 provide rules for determining the taxable income of a FSC and DISC, respectively, with respect to qualified sales and leases of export property and qualified services. The combined taxable income method available for determining a DISC's taxable income provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from sales and leases of export property and from services. In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under section 925 and 994, this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under sections 925(b)(2) and 994(b)(2) if used by the taxpayer. See Examples (22) and (23) of paragraph (g) of this section. In addition, the computation of combined taxable income is necessary to determine the applicability of the section 925(d) limitation and the "no loss" rules of the regulations under sections 925 and 994.

(iv) Effectively connected taxable income.

Nonresident alien individuals and foreign corporations engaged in trade or business within the United States, under sections 871(b)(1) and 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Such taxable income is determined in most instances by initially determining, under section 864(c), the amount of gross income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to sections 873 and 882(c), this section is applicable for purposes of determining the deductions from such gross income (other than the deduction for interest expense allowed to foreign corporations (see section 1.882-5)) which are to be taken into account in determining taxable income. See example (21) of paragraph (g) of this section.

(v) Foreign base company income.

Section 954 defines the term "foreign base company income" with respect to controlled foreign corporations. Section 954(b)(5) provides that in determining foreign base company income the gross income shall be reduced by the deductions of the controlled foreign corporation "properly allocable to such income". This section provides rules for identifying which deductions are properly allocable to foreign base company income.

(vi) Other operative sections.

The rules provided in this section also apply in determining--

(A) The amount of foreign source items of tax preference under section 58(g) determined for purposes of the minimum tax;

(B) The amount of foreign mineral income under section 901(e);

(C)[Reserved]

(D) The amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907;

(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation which has an election in effect under section 936;

(F) The exclusion for income from Puerto Rico for residents of Puerto Rico under section 933;

(G) The limitation under section 934 on the maximum reduction in income tax liability incurred to the Virgin Islands;

(H) The income derived from Guam by an individual who is subject to section 935;

(I) The special deduction granted to China Trade Act corporations under section 941;

(J) The amount of certain U.S. source income excluded from the Subpart F income of a controlled foreign corporation under section 952(b);

(K) The amount of income from the insurance of U.S. risks under section 953(b)(5);

(L) The international boycott factor and the specifically attributable taxes and income under section 999; and

(M) The taxable income attributable to the operation of an agreement vessel under section 607 of the Merchant Marine Act of 1936, as amended, and the Capital Construction Fund Regulations thereunder (26 CFR, Part 3). See 26 CFR 3.2(b)(3).

(2) Application to more than one operative section.

(i) Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

(ii) When expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a DISC or former DISC and residual gross income, regardless of which of the administrative pricing methods of section 994 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the DISC or former DISC attributable to income of the DISC or former DISC as determined under the administrative pricing methods with respect to DISC or former DISC taxable years beginning after December 31, 1986. Accordingly, Example (22) of paragraph (g) of this section does not apply to distributions from a DISC or former DISC with respect to

DISC or former DISC taxable years beginning after December 31, 1986. This rule does not apply to the extent that the taxable income of the DISC or former DISC is determined under the section 994(a)(3) transfer pricing method. In addition, for taxable years beginning after December 31, 1986, in the case of expenses, losses, and other deductions that have been properly allocated and apportioned between combined gross income of a related supplier and a FSC and residual gross income, regardless of which of the administrative pricing methods of section 925 has been applied, such deductions are not also allocated and apportioned to gross income consisting of distributions from the FSC or former FSC which are attributable to the foreign trade income of the FSC or former FSC as determined under the administrative pricing methods. This rule does not apply to the extent that the foreign trade income of the FSC or former FSC is determined under the section 925(a)(3) transfer pricing method. See Example (23) of paragraph (g) of this section.

(3) Special rules of section 863(b).

(i) In general.

Special rules under section 863(b) provide for the application of rules of general apportionment provided in sections 1.863-3 to 1.863-5, to worldwide taxable income in order to attribute part of such worldwide taxable income to U.S. sources and the remainder of such worldwide taxable income to foreign sources. The activities specified in section 863(b) are--

(A) Transportation or other services rendered partly within and partly without the United States,

(B) Sales of personal property produced by the taxpayer within and sold without the United States, or produced by the taxpayer without and sold within the United States, and

(C) Sales within the United States of personal property purchased within a possession of the United States.

In the instances provided in sections 1.863-3 and 1.863-4 with respect to the activities described in (A), (B), and (C) of this subdivision, this section is applicable only in determining worldwide taxable income attributable to these activities.

(ii) Relationship of sections 861, 862, 863(a), and 863(b).

Sections 861, 862, 863(a), and 863(b) are the four provisions applicable in determining taxable income from specific sources. Each of these four provisions applies independently. Where a deduction has been allocated and apportioned to income under one of these four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under section 863(b) take precedence over the general rules of Code sections 861, 862 and 863(a). For example, where a deduction is allocable in whole or in part to gross income to which section 863(b) applies, such deduction or part thereof shall not otherwise be allocated under section 861, 862, or 863(a). However, where the gross income to which the deduction is allocable includes both gross income to which section 863(b) applies and gross income to which section 861, 862, or 863(a) applies, more than one section must be applied at the same time in order to determine the proper allocation and apportionment of the deduction.

(4) Adjustments made under other provisions of the Code.

(i) In general.

If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this section in order to reflect changes resulting from the adjustment. The recomputation made by the District Director shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the District Director to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent continues to incur expenses in connection with the supervision of the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the District Director to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(ii) Example.

X, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. X reported $1,500,000 as sales during the taxable year of which $1,000,000 was domestic sales and $500,000 was foreign sales. X took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. Thus, X allocated and apportioned the marketing department deduction as follows:

```
To gross income from domestic sales:

  $150,000 x ($1,000,000/$1,500,000)        $100,000

To gross income from foreign sales:

  $150,000 x ($500,000/$1,500,000)            50,000

                                             --------

     Total                                   150,000
```

On audit of X's return for the taxable year, the District Director adjusted, under section 482, X's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000, thereby increasing X's foreign sales and total sales by the same amount. As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

```
To gross income from domestic sales:

  $150,000 x ($1,000,000/$1,600,000)        $93,750

To gross income from foreign sales:
```

$150,000 x ($600,000/$1,600,000)	56,250

Total	150,000

(5) Verification of allocations and apportionments.

Since, under this section, allocations and apportionments are made on the basis of the factual relationship between deductions and gross income, the taxpayer is required to furnish, at the request of the District Director, information from which such factual relationships can be determined. In reviewing the overall limitation to the foreign tax credit of a domestic corporation, for example, the District Director should consider information which would enable him to determine the extent to which deductions attributable to functions performed in the United States are related to earning foreign source income, United States source income, or income from both sources. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. Thus, for example when requested by the District Director, the taxpayer shall make available any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of the taxpayer and arrange for the interview of such of its employees as the District Director deems desirable in order to determine the gross income to which deductions relate. See section 7602 and the regulations thereunder which generally provide for the examination of books and witnesses. See also section 905(b) and the regulations thereunder which require proof of foreign tax credits to the satisfaction of the Secretary or his delegate.

(g) General examples.

The following examples illustrate the principles of this section. In each example, unless otherwise specified, the operative section which is applied and gives rise to the statutory grouping of gross income is the overall limitation to the foreign tax credit under section 904(a). In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayer on a consistent basis from year to year (except in the case of the optional method for apportioning research and development expense under paragraph (e)(3)(iii) of section 1.861-8). Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

Example 1--[Reserved]

Example 2--[Reserved]

Example 3--[Reserved]

Example 4--[Reserved]

Example 5--[Reserved]

Example 6--[Reserved]

Example 7--[Reserved]

Example 8--[Reserved]

Example 9--[Reserved]

Example 10--[Reserved]

Example 11--[Reserved]

Example 12--[Reserved]

Example 13--[Reserved]

Example 14--[Reserved]

Example 15--[Reserved]

Example 16--[Reserved]

Example 17--Stewardship Expenses (Consolidation).

(i) Facts.

X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
	---------	---------
Total	550,000	370,000

Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitute stewardship expenses. The remainder of X's deductions ($20,000) relates to production of income from its plant in the United States.

(ii) Allocation.

In accordance with section 1.1502-4, each corporation must first compute its separate taxable income for purposes of computing the limitation on the foreign tax credit. X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to income earned from sources without the United States and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the overall limitation, the statutory grouping is gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, X, M, and N have separate taxable income (losses) from sources without the United States in the amounts of ($25,000), $150,000, and ($50,000), respectively, computed as follows:

	X	M	N

Foreign gross income	------	$250,000	$150,000
Less: Deductions			
allocable to foreign			
gross income	$25,000	100,000	200,000
	---------	--------	--------
Total, taxable			
income (loss)	(25,000)	150,000	(50,000)

Thus, in the combined computation of the overall limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000 ($150,000 of separate taxable income of M less $50,000 of losses of N and less $25,000 of losses of X).

Example 18--Stewardship and Supportive Expenses.

(i) Facts.

X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year. X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S	
(before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed	
in the United States	1,000,000

```
                                                         -----------
          Total gross income                             40,000,000
      Among other deductions, X incurs the
        following:
          Expenses of supervision department              1,600,000
          Charitable contributions                          100,000
```

X's Supervision Department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $1,000,000. The second type consists of stewardship activities which are in the nature of a management review and generally duplicate functions performed by the subsidiaries' own employees (and are, therefore, of a type described in section 1.482-2(b)(2)(ii) which would not be subject to an allocation under section 482). For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) Allocation.

The Department's outlay of $1,000,000 is the basis for the charge to U for services rendered, and therefore $1,000,000 is allocated to the fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U and V and royalties from t and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary services and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) Apportionment.

For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Supervision Department expenses and related supportive expenses which is allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the overall limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

```
The gross receipts of the subsidiaries were as

  follows:

     S                                     $4,000,000

     T                                      3,000,000

     U                                        500,000

     V                                      1,500,000

                                          -----------

     Total                                  9,000,000
```

Thus, the expenses of the Department are apportioned for purposes of the overall limitation as follows:

```
 Apportionment of stewardship expenses to

   the statutory grouping of gross income:

540,000 x [($3,000,000 + $500,000 + $1,500,000)/

$9,000,000]                                     $300,000

 Apportionment of supervisory expenses to

   the residual grouping of gross income:
```

$540,000 x $4,000,000/9,000,000	240,000

Total: Apportioned stewardship expense	$540,000

(iv) Allocation and apportionment of charitable contributions.

Pursuant to paragraph (e)(9) of this section, charitable contributions are generally treated as deductions which are not definitely related to any gross income and are, accordingly, apportioned ratably on the basis of gross income for purposes of the overall limitation as follows:

Apportionment of charitable contributions	
to the statutory grouping of gross income:	
$100,000 x [($2,000,000 + $1,000,000 +	
$1,000,000)/$40,000,000]	$10,000
Apportionment of charitable contributions	
to the residual grouping of gross income:	
$100,000 x [($32,000,000 + $3,000,000 +	
$1,000,000)/$40,000,000]	90,000

Total apportioned charitable contributions	100,000

Example 19--Supportive Expense.

(i) Facts.

X, a domestic corporation, purchases and sells products both in the United States and in foreign countries. X has no foreign subsidiary and no international department. During the taxable year, X incurs the following expenses with respect to its worldwide activities:

Personnel department expenses	$50,000
Training department expenses	35,000
General and administrative expenses	55,000

```
President's salary                         40,000

Sales manager's salary                     20,000

                                          --------

     Total                                200,000

                                         =========
```

X has domestic gross receipts from sales of $750,000 and foreign gross receipts from sales of $500,000 and has gross income from such sales in the same ratio, namely $300,000 from domestic sources and $200,000 from foreign sources.

(ii) Allocation.

The above expenses are definitely related and allocable to all of X's gross income derived from both domestic and foreign markets.

(iii) Apportionment.

For purposes of applying the overall limitation, the statutory grouping is gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deductions for its worldwide sales activities must be apportioned between these groupings. Company X in this example (unlike Company X in example (18)) does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000 deduction is as follows:

```
Apportionment of the $200,000 expense

  to the statutory grouping of

  gross income: $200,000 x

 [$500,000/($500,000 + $750,000)]           $80,000
```

```
Apportionment of the $200,000 expense to

            the residual grouping of gross income:

           $200,000 x [$750,000/($500,000 + $750,000)] 120,000

                                                      ---------

               Total apportioned supportive expense    200,000
```

Example 20--Supportive Expense.

(i) Facts.

Assume the same facts as above except that X's president devotes only 5 percent of his time to the foreign operations and 95 percent of his time to the domestic operations and that X's sales manager devotes approximately 10 percent of his time to foreign sales and 90 percent of his time to domestic sales.

(ii) Allocation.

The expenses incurred by X with respect to its worldwide activities are definitely related, and therefore allocable to X's gross income from both its foreign and domestic markets.

(iii) Apportionment.

On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

```
Apportionment of the $200,000 expense to

  the statutory grouping of gross income:

     President's salary: $40,000 x 5 pct      $2,000

     Sales manager's salary: $20,000 x 10 pct  2,000

     Remaining expenses: $140,000 x

     [$500,000/($500,000 + $750,000)]         56,000
```

```
                                                   --------
Subtotal: Apportionment of expense to
  statutory grouping                                60,000
                                                   ========
Apportionment of the $200,000 expense to
  the residual grouping of gross income:
     President's salary: $40,000 x 95 pct           38,000
     Sales manager's salary: $20,000 x 90 pct       18,000
     Remaining expenses: $140,000 x
       [$750,000/($500,000+$750,000)]               84,000
                                                   --------
Subtotal: Apportionment of expense to
  residual grouping                                140,000
                                                  =========
Total: Apportioned general and
  administrative expense                           200,000
```

Example 21--Supportive Expense.

(i) Facts.

X, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. X has no United States subsidiaries and no separate division to manage and oversee its business in the United States. X manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are X's only source of income. In 1977, X incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000. It has machine sales of $500,000, $1,000,000 and $1,000,000 on which it earns gross income of $200,000, $400,000 and $400,000 in the United States, country A, and country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with X's business in the United

States.

(ii) Allocation.

The $100,000 of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in country A, and in country B. The expenses are allocable to this class of income, even though X's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(iii) Apportionment.

Since X is a foreign corporation, the statutory grouping is gross income effectively connected with X's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts which would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

```
                Apportionment of general and administrative
                  expense to the statutory grouping, gross
                  income from sources within the United
                  States: $100,000 x [$200,000/
                  ($200,000 + $400,000 + $400,000)]          $20,000
           Apportionment of general and administrative
                  expense to the residual grouping, gross
                  income from sources without the United
                  States: $100,000 x [($400,000 + $400,000)/
                  ($200,000 + $400,000 + $400,000)]           80,000
                                                             --------
                     Total apportioned general and
```

```
administrative expense                100,000
```

Example 22--Domestic International Sales Corporations.

(i) Facts.

X, a domestic corporation, manufactures a line of kitchenware and sells it to retailers in the United States, France, and the United Kingdom. After the Domestic International Sales Corporation (DISC) legislation was passed in 1971, X established, as of January 1, 1972, a DISC and thereafter did all of its foreign marketing through sales by the DISC. In 1977 the DISC has total sales of $7,700,000 for which X's cost of goods sold is $6,000,000. Thus, the gross income attributable to exports through the DISC is $1,700,000 ($7,700,000-$6,000,000). Moreover, X has U.S. domestic sales of kitchenware of $12,000,000 on which it earned gross income of $900,000, and X receives royalty income from the foreign license of its kitchenware technology in the amount of $800,000. The DISC's expenses attributable to the resale of export property are $400,000 of which $300,000 qualify as export promotion expenses. X also incurs $125,000 of general and administrative expenses in connection with its domestic and foreign sales activities, and its foreign licensing activities. X and the DISC determine transfer prices charged on the basis of a single product grouping and the "50-50" combined taxable income method (without marginal costing) which permits the DISC to have a taxable income equal to 50 percent of the combined taxable income attributable to the production and sales of the export property, plus 10 percent of the DISC's export promotion expenses.

(ii) Allocation.

For purposes of determining combined taxable income of X and the DISC from export sales, general and administrative expenses of $125,000 must be allocated to and apportioned between gross income resulting from the production and sale of kitchenware for export, and from the production and sale of kitchenware for the domestic market. The deduction of $400,000 for expenses attributable to the resale of export property is allocated solely to gross income from the production and sale of kitchenware in foreign markets.

(iii) Apportionment.

Apportionment of expense takes place in two stages. In the first stage, for computing combined taxable income from the production and sale of export property, the general and administrative expense should be apportioned between the statutory grouping of gross income from the export of kitchenware and the residual grouping of gross income from domestic sales and foreign licenses. In the second stage, since the limitation on the foreign tax credit requires the use of a separate limitation with respect to dividends from a DISC (section 904(d)), the general and administrative expense should be apportioned between two statutory groupings, DISC dividends and foreign royalty income (for which the overall limitation is used), and the residual grouping of gross income from sales within the United States. In the first stage, in the absence of more specific or contrary information, the general and administrative expense may be apportioned on the basis of gross income in the respective groupings, as follows:

```
Apportionment of general and administrative
       expense to the statutory grouping, gross
       income from exports of kitchenware:
       $125,000 x [$1,700,000/
       ($1,700,000 + $900,000 + $800,000)]        $62,500
     Apportionment of general and administrative
       expense to the residual grouping, gross
       income from domestic sales of kitchenware
       and foreign royalty income from licensing
       kitchenware technology: $125,000 x
       [($900,000 + $800,000)/
       ($1,700,000 + $900,000 + $800,000)]         62,500
                                                  --------
          Total apportionment of general and
            administrative expense                125,000
```

On the basis of this apportionment, the combined taxable income, and the DISC portion of taxable income may be calculated as follows:

```
Gross income from exports       $1,700,000
Less:
     DISC expense for resale
```

```
          of export property           400,000


          Apportioned general and
           administrative expense        62,500
                                       ---------
                                                  $462,500
                                                  ---------
     Combined taxable income from production
     and export of kitchenware                   1,237,500
                                                 ==========
     DISC income:
          50 pct of combined taxable income        618,750
          10 pct of export promotion expense
            of $300,000                             30,000
                                                  ---------
          Total DISC income                        648,750
     DISC income as a percentage of combined
       taxable income                                 52.4
```

In the second stage, in the absence of more specific or contrary information, the general and administrative expense may also be apportioned on the basis of gross income in the respective groupings. Since DISC taxable income is 52.4 percent of combined taxable income, DISC gross income is treated as 52.4 percent of the gross income from exports $1,700,000. The apportionment follows:

```
     Apportionment of general and administrative
       expense to the statutory grouping, DISC
```

```
  dividends: $125,000 x [(0.524 x $1,700,000)/
  ($1,700,000 + $900,000 + $800,000)]           $32,750
Apportionment of general and administrative
  expense to the statutory grouping, foreign
  royalty income: $125,000 x [$800,000/
  ($1,700,000 + 900,000 + $800,000)]             29,412
Apportionment of general and administrative
  expense to the residual grouping, gross
  income from sources within the United
  States: $125,000 x [($900,000 + (0.476  x
  $1,700,000))/($1,700,000 + $900,000 +
  $800,000)]                                     62,838
                                                --------
 Total apportioned general and
   administrative expense                       125,000
```

(iv) This Example (22) applies only to DISC taxable years ending before January 1, 1987, and to distributions from a DISC or former DISC with respect to DISC or former DISC taxable years ending before January 1, 1987.

Example 23--[Reserved]

Example 24--[Reserved] For guidance, see section 1.861-8T(g) Example 24.

Example 25--Income Taxes.

(i) Facts.

X, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. X also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In 1988, X has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of

$1,000,000, of which $200,000 is foreign source general limitation income subject to a separate limitation under section 904(d)(1)(I) ("general limitation income") and $800,000 is domestic source income. States A, B, and C each determine X's income subject to tax within their state by making adjustments to X's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of X's payroll, property, and sales within each state as compared to X's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that X has taxable income of $550,000, $200,000, and $200,000 in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10 percent, 5 percent, and 2 percent, respectively, and X has total state income tax liabilities of $69,000 ($55,000 + $10,000 + $4,000), which it deducts as an expense for federal income tax purposes.

(ii) Allocation.

X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000 of X's income while only $800,000 is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000 of foreign source income. The deduction for state income taxes is therefore related and allocable to both X's foreign source and domestic source income.

(iii) Apportionment.

For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000 must be apportioned between these two groupings. Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on $800,000 of domestic source income and $150,000 of foreign source general limitation income.

```
State income tax deduction apportioned

            to foreign source general limitation

            income (statutory grouping):
```

```
        $69,000 x ($150,000/$950,000)             $10,895

      State income tax deduction apportioned

        to income from sources within the United

        States (residual grouping):

        $69,000 x ($800,000/$950,000)              58,105

                                                 ---------

           Total apportioned state income

             tax deduction                        $69,000
```

Example 26--Income Taxes.

(i) Facts.

Assume the same facts as in Example 25 except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to X's country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) Allocation.

X's deduction of $69,000 for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000 of X's $800,000 of domestic source income. X's state A tax of $55,000 is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000 ($200,000 + $200,000) of X's income of which only $250,000 ($800,000 - $550,000) is presumed to be domestic source, the deduction for the $14,000 of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(iii) Apportionment.

(A) For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000 for income taxes of states

B and C must be apportioned between these two groupings.

(B) Corporation X calculates the apportionment on the basis of the relative amounts of foreign source general limitation income and U.S. source income subject to state taxation.

```
States B and C income tax deduction
  apportioned to foreign source general
  limitation income (statutory grouping):
  $14,000  x  ($150,000/$400,000)           $5,250
States B and C income tax deduction
  apportioned to income from sources within
  the United States (residual grouping):
  $14,000  x  ($250,000/$400,000)            8,750
                                           ----------
     Total apportioned state income
       tax deduction                        $14,000
```

(C) Of X's total income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $5,250. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750 ($55,000 + $8,750).

Example 27-- Income Tax--

(i) Facts.

Assume the same facts as in Example 25 except that state A, in which X has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. X therefore has a total state income tax liability in 1988 of $14,000 ($10,000 paid to state B plus $4,000 paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) Allocation.

(A) X's deduction of $14,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the federal income tax return in the manner described in Examples 25 and 26. Unlike the facts in Examples 25 and 26, state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of X's income subject to state taxation is, therefore, $400,000 ($200,000 in state B and $200,000 in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore can not properly be compared to total U.S. source taxable income reported by X for federal income tax purposes, which does include income attributable to state A activities.

(B)(1) Accordingly, before applying the method used in Examples 25 and 26 to the facts of this example, it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to X's activities in state A, and then to reduce federal taxable income by that amount.

(2) Any reasonable method may be used to attribute taxable income to X's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA") attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts--property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales--and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in this example all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to X's country Y branch must be eliminated.

(C)(1) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by X's country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(2) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by X's country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of X's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in Example 26 must then be applied.

(3) If, for example, state A taxable income were determined to equal $550,000, then $550,000 of

U.S. source income for federal income tax purposes would be presumed to constitute state A taxable income. Under Example 26, the remaining $250,000 ($800,000 - $550,000) of U.S. source income for federal income tax purposes would be presumed to be subject to tax in states B and C. Since states B and C impose tax on $400,000, the application of Example 25 would result in a presumption that $150,000 is foreign source income and $250,000 is domestic source income. The deduction for the $14,000 of income taxes of states B and C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(iii) Apportionment.

The deduction of $14,000 for income taxes of states B and C is apportioned in the same manner as in Example 26. As a result, $5,250 of the $14,000 of state B and state C income taxes is apportioned to foreign source general limitation income ($14,000 x $150,000/$400,000), and $8,750 ($14,000 x $250,000/$400,000) of the $14,000 of state B and state C income taxes is apportioned to U.S. source income.

Example 28--Income Tax--

(i) Facts.

(A) Assume the same facts as in Example 25 (X has $1,000,000 of taxable income for federal income tax purposes, $800,000 of which is U.S. source income and $200,000 of which is foreign source general limitation income), except that $100,000 of X's $200,000 of foreign source general limitation income consists of dividends from first-tier controlled foreign corporations ("CFCs") (as defined in section 957(a) of the Code) which derive exclusively foreign source general limitation income. X owns stock representing 10 to 50 percent of the vote and value in such CFCs.

(B) State A taxable income is computed by first making adjustments to X's federal taxable income. These adjustments result in X having a total of $1,100,000 of apportionable taxable income for state A tax purposes. None of the $100,000 of adjustments made by state A relate to the dividends paid by the CFCs. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the "state apportionment fraction") that compares the relative amounts of X's payroll, property, and sales within state A with X's worldwide payroll, property and sales. An analysis of state A law indicates that state A law includes in its definition of the taxable business income of X which is apportionable to X's state A activities, dividends paid to X by its subsidiaries that are in the same business as X, but are less than 50 percent owned by X ("portfolio dividends"). The dividends received by X from the 10 to 50 percent owned first-tier CFCs, therefore, are considered to be portfolio dividends includable in apportionable business income for state A tax purposes. However, the factors of these CFCs are not included in the state A apportionment fraction for purposes of apportioning income to X's activities in the state. The comparison of X's state A factors with X's worldwide factors results in a state apportionment fraction of 50 percent. Applying this fraction to apportionable taxable income of $1,100,000, as determined under state law, results in attributing 50 percent of apportionable taxable income to state A, and produces total state A taxable income of $550,000. State A imposes an income tax at a rate of 10 percent on the amount of income that is attributed to state A, which results in $55,000 of tax imposed by state A.

(ii) Allocation.

(A) States A, B, and C impose income taxes of $69,000 which must be allocated to the classes of gross income upon which the taxes are imposed. A portion of X's federal income tax deduction of $55,000 for state A income tax is definitely related and thus allocable to the class of gross income consisting of foreign source portfolio dividends. A definite relationship exists between a deduction for state income tax and portfolio dividends when a state includes portfolio dividends in state taxable income apportionable to the state, but determines state taxable income by applying an apportionment fraction that excludes the factors of the corporations paying those dividends. By applying a state apportionment fraction that excludes factors of the corporations paying portfolio dividends to apportionable taxable income that includes the $100,000 of foreign source portfolio dividends, $50,000 (50 percent of the $100,000) of the portfolio dividends is attributed to X's activities in state A and subjected to state A income tax. Applying the state A income tax rate of 10 percent to the $50,000 of foreign source portfolio dividends subjected to state A income tax, $5,000 of X's $55,000 total state A income tax liability is definitely related and allocable to a class of gross income consisting of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends from the first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $5,000 of state A tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned. (If the total amount of state A tax imposed on foreign source portfolio dividends were to exceed the actual amount of X's state A income tax liability (for example, due to net operating losses), the actual amount of state A tax would be allocated entirely to those foreign source portfolio dividends.) After allocation of a portion of the state A tax to portfolio dividends, $50,000 ($55,000-$5,000) of state A tax remains to be allocated.

(B) A total of $64,000 (the aggregate of the $50,000 remaining state A tax, and the $10,000 and $4,000 of taxes imposed by states B and C, respectively) is to be allocated (as provided in Example 25) by comparing U.S. source taxable income (as determined under the Code) with the aggregate of the state taxable incomes determined by states A, B, and C (after reducing state apportionable taxable incomes by the amount of any portfolio dividends included in apportionable taxable income to which tax has been specifically allocated). X's state A taxable income, after reduction by the $50,000 of portfolio dividends taxed by state A, equals $500,000. X also has taxable income of $200,000 and $200,000 in states B and C, respectively. In the aggregate, therefore, states A, B, and C tax $900,000 of X's income, after excluding state taxable income attributable to portfolio dividends. Since X has only $800,000 of U.S. source taxable income for federal income tax purposes, it is presumed that state income taxes are imposed on $100,000 of foreign source income. The remaining deduction of $64,000 for state income taxes is therefore related and allocable to both foreign source and domestic source income and is subject to apportionment.

(iii) Apportionment.

For purposes of computing the foreign tax credit limitation, X's income is comprised of one statutory grouping, foreign source general limitation income, and one residual grouping, gross income from sources within the United States. The remaining state income tax deduction of $64,000 must be apportioned between these two groupings on the basis of relative amounts of foreign source general limitation taxable income and U.S. source taxable income subject to state taxation. In this case, the $64,000 of state income taxes is considered to be imposed on $800,000 of domestic source income and $100,000 of foreign source general limitation income and is apportioned as follows:

```
State income tax deduction apportioned
            to foreign source general limitation
            income (statutory grouping):
            $64,000  x  ($100,000/$900,000)             $7,111
          State income tax deduction apportioned
            to income from sources within the
            United States (residual grouping):
            $64,000  x  ($800,000/$900,000)              56,889
                                                      ---------
               Total apportioned state income
                 tax deduction                         $64,000
```

Of the total state income taxes of $69,000, the amount allocated and apportioned to foreign source general limitation income equals $12,111 ($5,000 + $7,111). The total amount of state income taxes allocated and apportioned to U.S. source income equals $56,889.

Example 29--Income Taxes--

(i) Facts.

(A) P, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states F, G, and H. P also has a branch in country Y which manufactures and distributes the same type of electronic equipment. In addition, P has three wholly owned subsidiaries, US1, US2, and FS, the latter a controlled foreign corporation ("CFC") as defined in section 957(a) of the Code. P also owns stock representing 10 to 50 percent of the vote and value of various other first-tier CFCs that derive exclusively foreign source general limitation income.

(B) In 1988, P derives $1,000,000 of federal taxable income (without taking into account the deduction for state income taxes), which consists of $250,000 of foreign source general limitation income and $750,000 of U.S. source income. The foreign source general limitation income consists of a $25,000 subpart F inclusion with respect to FS, $150,000 of dividends from the other first-tier CFCs deriving exclusively foreign source general limitation income, in which P owns stock representing 10 to 50 percent of the vote and value, and $75,000 of manufacturing and sales income derived by P's U.S. operations and country Y branch. The $750,000 of U.S. source income consists of manufacturing and sales income derived by P's U.S. operations.

(C) For federal income tax purposes, US1 derives $75,000 of taxable income, before deduction for state income taxes, which consists entirely of U.S. source income. US2, a so-called "80/20' corporation described in section 861(c)(1), derives $250,000 of federal taxable income before deduction for state or foreign income taxes, all of which is derived from foreign operations and consists entirely of foreign source general limitation income. FS is not engaged in a U.S. trade or business and derives $550,000 of foreign source general limitation income before deduction for foreign income taxes.

(D) State F imposes a corporate income tax of 10 percent of P's state F taxable income, which is determined by formulary apportionment of the total taxable income attributable to P's worldwide unitary business. State F determines P's taxable income for state F tax purposes by first making adjustments to the taxable income, as determined for federal income tax purposes, of the members of the unitary business group to determine the total taxable income of the group. State F then computes P's state taxable income by attributing a portion of that unitary business taxable income to activities of P that are conducted in state F. State F does this by multiplying the unitary business taxable income (federal taxable income with state adjustments) by a fraction (the 'state apportionment fraction") that compares the relative amounts of the unitary business group's payroll, property, and sales (the "factors") in state F with the payroll, property, and sales of the unitary business group. P is the only member of its unitary business group that has state F factors and that is thereby subject to state F income tax and filing requirements. State F defines the unitary business group to include any corporation more than 50 percent of which is directly or indirectly owned by a state F taxpayer and is engaged in the same unitary business. P's unitary business group, therefore, includes P, US1, US2, and FS, but does not include the 10 to 50 percent owned CFCs. The income of the unitary business group excludes intercompany dividends between members of the unitary business group and subpart F inclusions with respect to a member of the unitary business group. Dividends paid from nonmembers of the unitary group (the 10 to 50 percent owned CFCs) for state F tax purposes are referred to as "portfolio dividends" and are included in taxable income of the unitary business. None of the factors (in state F or worldwide) of the corporations paying portfolio dividends are included in the state F apportionment fraction for purposes of apportioning total taxable income of the unitary business to P's state F activities.

(E) After state adjustments to the taxable income of the unitary business group, as determined under federal tax principles, the total taxable income of P's unitary business group equals $2,000,000, consisting of $1,050,000 of P's income ($100,000 of foreign source manufacturing and sales income, $150,000 of foreign source portfolio dividends, and $800,000 of U.S. source manufacturing and sales income, but excluding the $25,000 subpart F inclusion attributable to FS since FS is a member of the unitary business group), $100,000 of US1's income (from sales made in the United States), $275,000 of US2's income (from an active business outside the United States), and $575,000 of FS's income. The differences between taxable income under federal tax principles and state F apportionable taxable income for P, US1, US2, and FS represent adjustments to taxable income under federal tax principles that are made pursuant to the tax laws of state F.

(F) The taxable income for each member of the unitary business group under federal tax principles and state law principles is summarized in the following table. (The items of income listed in the "Federal" column of the table refer to taxable income before deduction for state income tax.)

	Federal	State F
P		

U.S. source income	$750,000	$800,000
Foreign source general		
limitation income:		
Portfolio dividends	150,000	150,000
Subpart F income	25,000	0
Manufacturing and sales		
income	75,000	100,000
	-----------	----------
Total taxable income	1,000,000	1,050,000
US1		
U.S. source income	75,000	100,000
US2		
Foreign source general		
limitation income	250,000	275,000
FS		
Foreign source general		
limitation income	550,000	575,000
	-----------	----------
Taxable income of the		
unitary business group	-------	2,000,000
	===========	==========

(G) State F deems P to have state F taxable income of $500,000, which is determined by multiplying the total taxable income of the unitary business group ($2,000,000) by the group's state F apportionment fraction, which is assumed to be 25 percent in these facts. P's state F taxable income is then multiplied by the state F tax rate of 10 percent, resulting in a state F tax liability of $50,000. State G and state H, unlike state F, do not tax portfolio dividends. Although state G and state H apportion taxable income, respectively, on the basis of an apportionment fraction that compares state factors to total factors, state G and state H, unlike state F, do not apply a unitary business theory and consider only P's taxable income and factors in computing P's taxable income. P's taxable income under state G law equals $300,000, which is subject to a 5 percent tax rate resulting in a state G tax liability of $15,000. P's taxable income under state H law is $300,000, which is subject to a tax rate of 2 percent resulting in a state H tax liability of $6,000. P has a total federal income tax deduction for state income taxes of $71,000 ($50,000 + 15,000 + 6,000).

(ii) Allocation.

(A) P's deduction of $71,000 for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. Adjustments may be necessary, however, before aggregate state taxable incomes can be compared with U.S. source taxable income on the federal income tax return in the manner described in Examples 25 and 26. In allocating P's deduction for state income taxes, it is necessary first to determine the portion, if any, of the deduction that is definitely related and allocable to a particular class of gross income. A definite relationship exists between a deduction for state income tax and dividend income when a state includes portfolio dividends in state taxable income apportionable to the taxpayer's activities in the state, but determines state taxable income by applying an apportionment formula that excludes the factors of the corporations paying portfolio dividends.

(B) In this case, $150,000 of foreign source portfolio dividends are subject to a state F apportionment fraction of 25 percent, which results in a total of $37,500 of state F taxable income attributable to such dividends. As illustrated in Example 28, $3,750 ($150,000 x 25 percent state F apportionment percentage x 10 percent state F tax rate) of P's state F income tax is definitely related and allocable to a class of gross income consisting entirely of the foreign source portfolio dividends. Since under the look-through rules of section 904(d)(3) the foreign source portfolio dividends paid by first-tier CFCs are included within the general limitation described in section 904(d)(1)(I), the $3,750 of state F tax on foreign source portfolio dividends is allocated entirely to foreign source general limitation income and, therefore, is not apportioned.

(C) After reducing state F taxable income of the unitary business group by the taxable income attributable to portfolio dividends, P's remaining state F taxable income equals $462,500 ($500,000 - $37,500), the portion of the taxable income of the unitary business that state F attributes to P's activities in state F. Accordingly, in order to allocate and apportion the remaining $46,250 of state F tax ($50,000 of state F tax minus the $3,750 of state F tax allocated to foreign source portfolio dividends), it is necessary first to determine if state F is taxing only P's non-unitary taxable income (as defined below) or is imposing its tax partly on other unitary business income that is attributed under state F law to P's activities in state F. P's state F non-unitary taxable income is computed by applying the state F apportionment formula, solely on the basis of P's income (excluding portfolio dividends) and state F apportionment factors. If the state F taxable income (after reduction by the portfolio dividends attributed to state F) attributed to P under state F law exceeds P's non-unitary taxable income, a portion of the state F tax must be allocated and apportioned on the basis of the other unitary business income that is attributed to and taxable to P under state F law. If P's non-unitary taxable income equals or exceeds the $462,500 of remaining state F taxable income, it is presumed that state F is only taxing P's non-unitary taxable income, so that the entire amount of the remaining state F tax should be allocated and apportioned in the manner described in Example 25.

(D) If P's non-unitary taxable income is less than the $462,500 of remaining state F taxable income (after reduction for the $37,500 of state F taxable income attributable to portfolio dividends), it is presumed that state F is attributing to P, and taxing P upon, other unitary business income. In such a case, it is necessary to determine if state F is attributing to P, and imposing its income tax on, a part of the foreign source income that would be generally presumed under separate accounting to be the income of foreign affiliates and 80/20 companies included in the unitary group, or whether state F is limiting the income it attributes to P, and its taxation of P, to the U.S. source income that would be generally presumed under separate accounting to be the income of domestic members of the unitary group.

(E) Assume for purposes of this example that the non-unitary taxable income attributable to P equals $396,000, computed by multiplying P's state F taxable income of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) by P's non-unitary state F apportionment fraction, which is assumed to be 44 percent. Because P's non-unitary taxable income of $396,000 is less than the $462,500 of remaining state F taxable income, state F is presumed to be attributing to P and taxing the income that would have been generally attributed under separate accounting to P's affiliates in the unitary group. To determine if state F tax is being imposed on members of the unitary group (other than P) that produce foreign source income, it is necessary to compute a hypothetical state F taxable income for all companies in the unitary group with significant U.S. operations. (For this purpose, the hypothetical group of companies with significant domestic operations is referred to as the "water's edge group.") State F is presumed to be attributing to P and taxing income that would have been generally attributable under separate accounting to foreign corporations and 80/20 companies to the extent that the remaining state F taxable income ($462,500) of P exceeds the hypothetical state F taxable income that would have been attributed under state F law to P if state F had defined the unitary group to be the water's edge group.

(F) The members of the water's edge group would have been P and US1. The unitary business income of this water's edge group is $1,000,000, the sum of $900,000 (P's state F taxable income (before state F apportionment) of $1,050,000 less the $150,000 of foreign source portfolio dividends) and $100,000 (US1's state F taxable income). For purposes of this example, the state F apportionment fraction determined on a unitary basis for this water's edge group is assumed to equal 40 percent, the average of P and US1's state F payroll, property, and sales factor ratios (the water's edge group's state F factors over its worldwide factors). Applying this apportionment fraction to the $1,000,000 of unitary business income of the water's edge group yields state F water's edge taxable income of $400,000. The excess of the remaining $462,500 of P's state F taxable income over the $400,000 of P's state F water's edge taxable income equals $62,500, and is attributable to the inclusion of US2 and FS in the unitary group. The state F tax attributable to the $62,500 of taxable income attributed to P under state F law, and that would have generally been attributed to US2 and FS under non-unitary accounting, equals $6,250 and is allocated entirely to a class of gross income consisting of foreign source general limitation income, because the income of FS and US2 consists entirely of such income. After the $6,250 of state F tax attributable to US2 and FS is subtracted from the remaining $46,250 of net state F tax, P has $40,000 of state F tax remaining to be allocated and apportioned.

(G) To the extent that the remainder of P's state F taxable income ($400,000) exceeds P's non-unitary state F taxable income ($396,000), it is presumed that state F is attributing to and imposing on P a tax on U.S. source income that would have been attributed under separate accounting to members of the water's edge group other than P. In these facts, the $4,000 difference in P's state F taxable income results from the inclusion of US1 in the unitary group. The $400 of P's state F tax attributable to this $4,000 is allocated entirely to P's U.S. source income. P's remaining $39,600 of state F tax ($40,000 of P's state F tax resulting from the attribution of P of income that would have been attributed under non-unitary accounting to other members of the water's edge group, minus $400 of state F tax attributable to US1 and allocated to P's U.S. source income) is the state F tax attributable to P's non-unitary state F taxable income that is to be allocated and apportioned together with P's state G tax of $15,000 and state H tax of $6,000 as illustrated in Example 25.

(H) In allocating the $60,600 of state tax liabilities ($39,600 state F tax attributable to P's non-unitary state F income + $15,000 state G tax + $6,000 state H tax) under Example 25, P's state taxable income in state G and state H ($300,000 + $300,000) must be added to P's non-unitary state F taxable income ($396,000). The resulting $996,000 of combined state taxable incomes is compared with $750,000 of U.S. source income on P's federal income tax return. Because P's combined state taxable incomes exceeds P's federal U.S. source taxable income, it is presumed that the remaining $60,600 of P's total state income taxes is imposed in part on foreign source income. Accordingly, P's remaining deduction of $60,600 ($39,600 + $15,000 + $6,000) for state income taxes is related and allocable to both P's foreign source and domestic source income and is subject to apportionment.

(iii) Apportionment.

The $60,600 of state taxes (the remaining $39,600 of state F tax + $15,000 of state G tax + $6,000 of state H tax) must be apportioned between foreign source general limitation income and U.S. source income for federal income tax purposes. This apportionment is based upon the relative amounts of foreign source general limitation taxable income and U.S. source taxable income comprising the $996,000 of income subject to tax by the states, after reducing the total amount of income subject to tax by the portfolio dividends and the income attributed to P under state F law that would have been attributed under arm's length principles to other members of P's state F unitary business group. The deduction for the $60,600 of state income taxes is apportioned as follows:

```
State income tax deduction apportioned
            to foreign source general limitation
            income (statutory grouping):
            $60,600 x ($246,000/$996,000)             $14,967
          State income tax deduction apportioned
            to income from sources within the United
            States (residual grouping):
            $60,600 x ($750,000/$996,000)              45,633
                                                     ---------
          Total apportioned state income tax
            deduction                                  60,600
```

Of the total state income taxes of $71,000, the amount allocated and apportioned to foreign source general limitation income is $24,967--the sum of $14,967 of state F, state G, and state H taxes apportioned to foreign source general limitation income, $3,750 of state F tax allocated to foreign source apportionable dividend income, and the $6,250 of state F tax allocated to foreign source general limitation income as the result of state F's worldwide unitary business theory of taxation. The total amount of state income taxes allocated and apportioned to U.S. source income equals $46,033--the sum of the $400 of state F tax attributable to the inclusion of US1 in the state F unitary business group and $45,633 of combined state F, G, and H tax apportioned under the method provided in Example 25.

Example 30--Income Taxes--

(i) Facts.

(A) As in Example 17 of section 1.861-8(g), X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is from sources within South America, and all of N's income is from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign source taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign source loss of $50,000. O has gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike Example 17 of section 1.861-8(g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in Example 25, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the "state apportionment fraction") that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(ii) Allocation and apportionment.

In accordance with section 1.1502-4, each corporation must first compute its separate taxable income for purposes of computing the consolidated limitation on the foreign tax credit. Assume that under Example 29, it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under Example 17, without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated foreign tax credit limitation.

Example 31--Income Taxes--

(i) Facts.

Assume that the facts are the same as in Example 29, except that state G requires P to adjust its federal taxable income by depreciating an asset at a different rate than is allowed P under the Internal Revenue Code for the same asset. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes its taxable income under state G law by using the rate of depreciation that it is entitled to use under the Code, and uses this recomputed amount in applying the methodology of Example 25.

(ii) Allocation.

P's modification of its state G taxable income is permissible. Under the methodology of Example 25, this modification of state G taxable income will produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign sources income.

Example 32--Income Taxes--

(i) Facts.

Assume the facts are the same as Example 29, except that P's state F taxable income differs from the amount of its U.S. source income under federal income tax principles solely because state F determines P's state taxable income under a worldwide unitary business theory instead of the arm's length principles applied in the Code. Before using the methodology of Example 25 to determine whether a portion of its deduction for state income taxes is allocable to a class of gross income that includes foreign source income, P recomputes state F taxable income under the arm's length principles applied in the Code. P substitutes that recomputed amount for the amount of taxable income actually determined under state F law in applying the methodology of Example 25.

(ii) Allocation.

P's modification of state F taxable income does not accurately reflect the factual relationship between the deduction for state F income tax and the income on which the tax is imposed, because there is no factual relationship between the state F income tax and the state F taxable income as recomputed under Code principles. State F does not impose its income tax upon P's income as it might have been defined under the Internal Revenue Code. Consequently, P's modification of state F taxable income is impermissible because it will not produce a reasonable determination of the portion (if any) of P's state income taxes that is allocable to a class of gross income that includes foreign source income.

Example 33--Income Taxes--

(i) Facts.

Assume the same facts as in Example 29, except that state G does not impose an income tax on corporations, and P's non-unitary state F taxable income equals $462,500. Thus only $56,000 of state income taxes ($50,000 of state F income tax and $6,000 of state H income tax) are deductible and required to be allocated and (if necessary) apportioned. As in Example 29, P has $800,000 of aggregate state taxable income ($500,000 of state F taxable income and $300,000 of state H taxable income).

(ii) Method One.

Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in section 1.861-8 (e)(6)(ii)(D)(2) ("Method One").

(A) Step One--Specific allocation to foreign source portfolio dividends.

P applies the methodology of paragraph (ii) of Example 28 to determine the portion of the deduction that must be allocated to a class of gross income consisting solely of foreign source portfolio dividends. As illustrated in paragraphs (ii) (A) and (B) of Example 29, $3,750 of the deduction for state F income tax is attributable to the $37,500 of foreign source portfolio dividends attributed under state F law to P's activities in state F. Thus $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends). Because the remaining amount of state F taxable income ($462,500) equals P's non-unitary state F taxable income, no further specific allocation of state tax is required.

(B) Step Two--Adjustment of U.S. source federal taxable income.

P applies the methodology illustrated in paragraph (ii) of Example 27 (including the rules of UDITPA described therein) to determine the amount of its federal taxable income attributable to its activities in state G. Assume that P determines under this methodology that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) Step Three--Allocation.

The portion of P's deduction for state income tax remaining to be allocated equals $52,250 ($56,000 minus the $3,750 specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(2)(iii) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with an amount equal to 110% of its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds 110% of P's adjusted U.S. source federal taxable income ($495,000, or 110% of $450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) Step Four--Apportionment.

P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to 110% of P's adjusted U.S. source federal taxable income. The remainder of the deduction must be apportioned to foreign source general limitation income.

```
Amount of deduction to be apportioned        $52,250.00
```

```
Less portion of deduction to be
  apportioned to income from sources
  within the United States (residual
  grouping):
  ($52,250 x ($495,000/$762,500)            $33,919.67
                                           ------------
Equals Portion of deduction to be
  apportioned to foreign source general
  limitation income (statutory grouping):    $18,330.33
```

(iii) Method Two.

Assume that P has elected to allocate and apportion its deduction for state income tax under the safe harbor method provided in section 1.861-8(e)(6)(ii)(D)(3) ("Method Two").

(A) Step One--Specific allocation.

Step One of Method Two is the same as Step One of Method One. Therefore, as described in paragraph (A) of paragraph (ii) above, $3,750 of P's deduction for state income tax must be specifically allocated to a class of gross income consisting solely of $37,500 of foreign source portfolio dividends. No apportionment of the $3,750 is necessary. P's adjusted state taxable income is $762,500 (aggregate state taxable income of $800,000 reduced by $37,500 of foreign source portfolio dividends).

(B) Step Two--Adjustment of U.S. source federal taxable income.

Step Two of Method Two is the same as Step Two of Method One. Therefore, as described in paragraph (B) of paragraph (ii) above, assume that P determines that $300,000 of its federal taxable income is attributable to activities in state G. P's adjusted U.S. source federal taxable income equals $450,000 ($750,000 minus the $300,000 attributed to P's activities in state G).

(C) Step Three--Allocation.

The portion of P's deduction for state income tax remaining to be allocated equals $52,250

($56,000 minus the $3,750 of state F income tax specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(3)(iii) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds P's adjusted U.S. source federal taxable income ($450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) Step Four--Apportionment.

P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to P's adjusted U.S. source federal taxable income.

```
Amount of deduction to be apportioned        $52,250.00

Less portion of deduction initially

  apportioned to income from sources

  within the United States (residual

  grouping):

  $52,250  x  ($450,000/$762,500)             30,836.07

                                             -----------

Remainder requiring further

  apportionment: $52,250  x

  ($312,500/$762,500)                         21,413.93
```

The remainder of $21,413.93 must be further apportioned between foreign source general limitation income and U.S. source federal taxable income in the same proportions that P's adjusted U.S. source federal taxable income and foreign source general limitation income bear to P's total federal taxable income (taking into account the adjustment of U.S. source federal taxable income) and reduced by the amount of foreign source portfolio dividends to which the tax has been specifically allocated.

```
     Portion of remainder apportioned to

                    foreign source general limitation

                    income (statutory grouping):

                    $21,413.93 x ($212,500/$662,500)           $6,868.62

                  Remaining state income tax deduction

                    to be apportioned to income from

                    sources within the United States

                    (residual grouping):

                    $21,413.93  x  ($450,000/$662,500)         14,545.31
```

Of P's total deduction of $56,000 for state income tax, the portion allocated and apportioned to foreign source general limitation income equals $10,618.62--the sum of $6,868.62 apportioned under Step Four and the $3,750.00 specifically allocated to foreign source portfolio dividend income under Step One. The portion of the deduction allocated and apportioned to U.S. source income equals $45,381.38--the sum of the $30,836.07 and the $14,545.31 apportioned under Step Four.

(Secs. 882(c) and 7805 of the Internal Revenue Code of 1954 (80 Stat. 1556; 26 U.S.C. 882(c) and 68A Stat. 917; 26 U.S.C. 7805))

[T.D. 7456, 42 FR 1195, Jan. 6, 1977, as amended by T.D. 7749, 46 FR 1683, Jan. 7, 1981; T.D. 7939, 49 FR 4207, Feb. 3, 1984; T.D. 8228, 53 FR 35474, Sept. 14, 1988; T.D. 8286, 55 FR 3052, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; corrected by 60 FR 36669, July 18, 1995; T.D. 8646, 60 FR 66502-66510, Dec. 22, 1995; T.D. 8805, Federal Register: January 11, 1999 (Volume 64, Number 6)] [Page 1505-1516]

§ 882. Tax on income of foreign corporations connected with United States business

How Current is This?

(a) Imposition of tax

(1) In general

A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11, 55, 59A, or 1201 (a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

(2) Determination of taxable income

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

(3) [Cross reference●1]

For special tax treatment of gain or loss from the disposition by a foreign corporation of a United States real property interest, see section 897.

(b) Gross income

In the case of a foreign corporation, except where the context clearly indicates otherwise, gross income includes only—

(1) gross 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, and

(2) gross income which is effectively connected with the conduct of a trade or business within the United States.

(c) Allowance of deductions and credits

(1) Allocation of deductions

(A) General rule

In the case of a foreign corporation, the deductions shall be allowed only for purposes of subsection (a) and (except as provided by subparagraph (B)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary.

(B) Charitable contributions

The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income which is effectively connected with the conduct of a trade or business within the United States.

(2) Deductions and credits allowed only if return filed

A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits. The preceding sentence shall not apply for purposes of the tax imposed by section 541 (relating to personal holding company tax), and shall not be construed to deny the credit provided by section 33 for tax withheld at source or the credit provided by section 34 for certain uses of gasoline.

(3) Foreign tax credit

Except as provided by section 906, foreign corporations shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(4) Cross reference

For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906 (b)(1).

(d) Election to treat real property income as income connected with United States business

(1) In general

A foreign corporation which during the taxable year derives any income —

(A) from real property located in the United States, or from any interest in such real property, including

(i) gains from the sale or exchange of real property or an interest therein,

(ii) rents or royalties from mines, wells, or other natural deposits, and

(iii) gains described in section 631 (b) or (c), and

(B) which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year.

(2) Election after revocation, etc.

Paragraphs (2) and (3) of section 871 (d) shall apply in respect of elections under this subsection in the same manner and to the same extent as they apply in respect of elections under section 871 (d).

(e) Interest on United States obligations received by banks organized in possessions

In the case of a corporation created or organized in, or under the law of, a possession of the United States which is carrying on the banking business in a possession of the United States, interest on obligations of the United States which is not portfolio interest (as defined in section 881 (c)(2)) shall —

(1) for purposes of this subpart, be treated as income which is effectively connected with the conduct of a trade or business within the United States, and

(2) shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year.

(f) Returns of tax by agent

If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent.

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[1] Par. (3) heading editorially supplied.

§ 904. Limitation on credit

(a) Limitation

The total amount of the credit taken under section 901 (a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) Taxable income for purpose of computing limitation

(1) Personal exemptions

For purposes of subsection (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642 (b).

(2) Capital gains

For purposes of this section—

(A) In general

Taxable income from sources outside the United States shall include gain from the sale or exchange of capital assets only to the extent of foreign source capital gain net income.

(B) Special rules where capital gain rate differential

In the case of any taxable year for which there is a capital gain rate differential—

(i) in lieu of applying subparagraph (A), the taxable income from sources outside the United States shall include gain from the sale or exchange of capital assets only in an amount equal to foreign source capital gain net income reduced by the rate differential portion of foreign source net capital gain,

(ii) the entire taxable income shall include gain from the sale or exchange of capital assets only in an amount equal to capital gain net income reduced by the rate differential portion of net capital gain, and

(iii) for purposes of determining taxable income from sources outside the United States, any net capital loss (and any amount which is a short-term capital loss under section 1212 (a)) from sources outside the United States to the extent taken into account in determining capital gain net income for the taxable year shall be reduced by an amount equal to the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain.

(C) Coordination with capital gains rates

The Secretary may by regulations modify the application of this paragraph and paragraph (3) to the extent necessary to properly reflect any capital gain rate differential under section 1 (h) or 1201 (a) and the computation of net capital gain.

(3) Definitions

For purposes of this subsection—

(A) Foreign source capital gain net income

The term "foreign source capital gain net income" means the lesser of—

(i) capital gain net income from sources without the United States, or

(ii) capital gain net income.

(B) Foreign source net capital gain

The term "foreign source net capital gain" means the lesser of—

(i) net capital gain from sources without the United States, or

(ii) net capital gain.

(C) Section 1231 gains

The term "gain from the sale or exchange of capital assets" includes any gain so treated under section 1231.

(D) Capital gain rate differential

There is a capital gain rate differential for any taxable year if—

(i) in the case of a taxpayer other than a corporation, subsection (h) of section 1 applies to such taxable year, or

(ii) in the case of a corporation, any rate of tax imposed by section 11, 511, or 831 (a) or (b) (whichever applies) exceeds the alternative rate of tax under section 1201 (a) (determined without regard to the last sentence of section 11 (b)(1)).

(E) Rate differential portion

(i) In general The rate differential portion of foreign source net capital gain, net capital gain, or the excess of net capital gain from sources within the United States over net capital gain, as the case may be, is the same proportion of such amount as—

(I) the excess of the highest applicable tax rate over the alternative tax rate, bears to

(II) the highest applicable tax rate.

(ii) Highest applicable tax rate For purposes of clause (i), the term "highest applicable tax rate" means—

(I) in the case of a taxpayer other than a corporation, the highest rate of tax set forth in subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies), or

(II) in the case of a corporation, the highest rate of tax specified in section 11 (b).

(iii) Alternative tax rate For purposes of clause (i), the term "alternative tax rate" means—

(I) in the case of a taxpayer other than a corporation, the alternative rate of tax determined under section 1 (h), or

(II) in the case of a corporation, the alternative rate of tax under section 1201 (a).

(4) Coordination with section 936

For purposes of subsection (a), in the case of a corporation, the taxable income shall not include any portion thereof taken into account for purposes of the credit (if any) allowed by section 936 (without regard to subsections (a)(4) and (i) thereof).

(c) Carryback and carryover of excess tax paid

Any amount by which all taxes paid or accrued to foreign countries or possessions of the United States for any taxable year for which the taxpayer chooses to have the benefits of this subpart exceed the limitation under subsection (a) shall be deemed taxes paid or accrued to foreign countries or possessions of the United States in the first preceding taxable year and in any of the first 10 succeeding taxable years, in that order and to the extent not deemed taxes paid or accrued in a prior taxable year, in the amount by which the limitation under subsection (a) for such preceding or succeeding taxable year exceeds the sum of the taxes paid or accrued to foreign countries or possessions of the United States for such preceding or succeeding taxable year and the amount of the taxes for any taxable year earlier than the current taxable year which shall be deemed to have been paid or accrued in such preceding or subsequent taxable year (whether or not the taxpayer chooses to have the benefits of this subpart with respect to such earlier taxable year). Such amount deemed paid or accrued in any year may be availed of only as a tax credit and not as a deduction and only if the taxpayer for such year chooses to have the benefits of this subpart as to taxes paid or accrued for that year to foreign countries or possessions of the United States.

(d) Separate application of section with respect to certain categories of income

(1) In general

The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to each of the following items of income:

(A) passive income,

(B) high withholding tax interest,

(C) financial services income,

(D) shipping income,

[(E) Repealed. Pub. L. 108–357, title IV, § 403(b)(1), Oct. 22, 2004, 118 Stat. 1493]

(F) dividends from a DISC or former DISC (as defined in section 992 (a)) to the extent such dividends are treated as income from sources without the United States,

(G) taxable income attributable to foreign trade income (within the meaning of section 923 (b)),[1]

(H) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923 (b)) [1] or interest or carrying charges (as defined in section 927 (d)(1)) [1] derived from a transaction which results in foreign trade income (as defined in section 923 (b)) [1], and

(I) income other than income described in any of the preceding subparagraphs.

(2) Definitions and special rules

For purposes of this subsection—

(A) Passive income

(i) In general Except as otherwise provided in this subparagraph, the term "passive income" means any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as defined in section 954 (c)).

(ii) Certain amounts included Except as provided in clause (iii), the term "passive income" includes, except as provided in subparagraph (E)(iii) [1] or paragraph (3)(I), any amount includible in gross income under section 1293 (relating to certain passive foreign investment companies).

(iii) Exceptions The term "passive income" shall not include—

(I) any income described in a subparagraph of paragraph (1) other than subparagraph (A),

(II) any export financing interest, and

(III) any high-taxed income.

(iv) Clarification of application of section 864 (d)(6) In determining whether any income is of a kind which would be foreign personal holding company income, the rules of section 864 (d)(6) shall apply only in the case of income of a controlled foreign corporation.

(B) High withholding tax interest

(i) In general Except as otherwise provided in this subparagraph, the term "high withholding tax interest" means any interest if—

(I) such interest is subject to a withholding tax of a foreign country or possession of the United States (or other tax determined on a gross basis), and

(II) the rate of such tax applicable to such interest is at least 5 percent.

(ii) Exception for export financing The term "high withholding tax interest" shall not include any export financing interest.

(iii) Regulations The Secretary may by regulations provide that—

(I) amounts (not otherwise high withholding tax interest) shall be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of this subparagraph, and

(II) a tax shall not be treated as a withholding tax or other tax imposed on a gross basis if such tax is in the nature of a prepayment of a tax imposed on a net basis.

(C) Financial services income

(i) In general Except as otherwise provided in this subparagraph, the term "financial services income" means any income which is received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, and which is—

(I) described in clause (ii),

(II) passive income (determined without regard to subclauses (I) and (III) of subparagraph (A)(iii)), or

(III) export financing interest which (but for subparagraph (B)(ii)) would be high withholding tax interest.

(ii) General description of financial services income Income is described in this clause if such income is—

(I) derived in the active conduct of a banking, financing, or similar business,

(II) derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, or

(III) of a kind which would be insurance income as defined in section 953 (a) determined without regard to those provisions of paragraph (1)(A) of such section which limit insurance income to income from countries other than the country in which the corporation was created or organized.

(iii) Exceptions The term "financial services income" does not include—

(I) any high withholding tax interest, and

(II) any export financing interest not described in clause (i)(III).

(D) Shipping income

The term "shipping income" means any income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in section 954 (f)).[1] Such term does not include any financial services income.

(E) Noncontrolled section 902 corporation

(i) In general The term "noncontrolled section 902 corporation" means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902 (a) (or, for purposes of applying paragraph (3) or (4), the requirements of section 902 (b)). A controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation.

(ii) Treatment of inclusions under section 1293 If any foreign corporation is a non-controlled section 902 corporation with respect to the taxpayer, any inclusion under section 1293 with respect to such corporation shall be treated as a dividend from such corporation.

(F) High-taxed income

The term "high-taxed income" means any income which (but for this subparagraph) would be passive income if the sum of—

(i) the foreign income taxes paid or accrued by the taxpayer with respect to such income, and

(ii) the foreign income taxes deemed paid by the taxpayer with respect to such income under section 902 or 960,

exceeds the highest rate of tax specified in section 1 or 11 (whichever applies) multiplied by the amount of such income (determined with regard to section 78). For purposes of the preceding sentence, the term "foreign income taxes" means any income, war profits, or excess profits tax imposed by any foreign country or possession of the United States.

(G) Export financing interest

For purposes of this paragraph, the term "export financing interest" means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property—

(i) which is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, and

(ii) not more than 50 percent of the fair market value of which is attributable to products imported into the United States.

For purposes of clause (ii), the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.

(H) Treatment of income tax base differences

(i) In general In the case of taxable years beginning after December 31, 2006, tax imposed under the law of a foreign country or possession of the United States on an amount which does not constitute income under United States tax principles shall be treated as imposed on income described in paragraph (1)(B).

(ii) Special rule for years before 2007

(I) In general In the case of taxes paid or accrued in taxable years beginning after December 31, 2004, and before January 1, 2007, a taxpayer may elect to treat tax imposed under the law of a foreign country or possession of the United States on an amount which does not constitute income under United States tax principles as tax imposed on income described in subparagraph (C) or (I) of paragraph (1).

(II) Election irrevocable Any such election shall apply to the taxable year for which made and all subsequent taxable years described in subclause (I) unless revoked with the consent of the Secretary.

(I) Related person

For purposes of this paragraph, the term "related person" has the meaning given such term by section 954 (d)(3), except that such section shall be applied by substituting "the person with respect to whom the determination is being made" for "controlled foreign corporation" each place it appears.

(J) Transitional rule

For purposes of paragraph (1)—

(i) taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income which was described in subparagraph (A) of paragraph (1) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) shall be treated as taxes paid or accrued with respect to income described in subparagraph (A) of paragraph (1) (as in effect after such date),

(ii) taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income which was described in subparagraph (E) of paragraph (1) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) shall be treated as taxes paid or accrued with respect to income described in subparagraph (I) of paragraph (1) (as in effect after such date) except that—

(I) such taxes shall be treated as paid or accrued with respect to shipping income to the extent the taxpayer establishes to the satisfaction of the Secretary that such taxes were paid or accrued with respect to such income,

(II) in the case of a person described in subparagraph (C)(i), such taxes shall be treated as paid or accrued with respect to financial services income to the extent the taxpayer establishes to the satisfaction of the Secretary that such taxes were paid or accrued with respect to such income, and

(III) such taxes shall be treated as paid or accrued with respect to high withholding tax interest to the extent the taxpayer establishes to the satisfaction of the Secretary that such taxes were paid or accrued with respect to such income, and

(iii) taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income described in any other subparagraph of paragraph (1) (as so in effect before such date) shall be treated as taxes paid or accrued with respect to income described in the corresponding subparagraph of paragraph (1) (as so in effect after such date).

(3) Look-thru in case of controlled foreign corporations

(A) In general

Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as income in a separate category.

(B) Subpart F inclusions

Any amount included in gross income under section 951 (a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income in such category.

(C) Interest, rents, and royalties

Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent it is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation in such category.

(D) Dividends

Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category in proportion to the ratio of—

(i) the portion of the earnings and profits attributable to income in such category, to

(ii) the total amount of earnings and profits.

(E) Look-thru applies only where subpart F -applies

If a controlled foreign corporation meets the requirements of section 954 (b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954 (a) without regard to section 954 (b)(5)) and none of its gross insurance income (as defined in section 954 (b)(3)(C)) for such taxable year shall be treated as income in a separate category, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as income in a separate category if the requirements of section 954 (b)(4) are met with respect to such income.

(F) Separate category

For purposes of this paragraph—

(i) In general Except as provided in clause (ii), the term "separate category" means any category of income described in subparagraph (A), (B), (C), or (D) of paragraph (1).

(ii) Coordination with high-taxed income provisions

(I) In determining whether any income of a controlled foreign corporation is in a separate category, subclause (III) of paragraph (2)(A)(iii) shall not apply.

(II) Any income of the taxpayer which is treated as income in a separate category under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

(G) Dividend

For purposes of this paragraph, the term "dividend" includes any amount included in gross income in section 951 (a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951 (a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951 (a)(1)(A).

(H) Exception for certain high withholding tax interest

This paragraph shall not apply to any amount which—

(i) without regard to this paragraph, is high withholding tax interest (including any amount treated as high withholding tax interest under paragraph (2)(B)(iii)), and

(ii) would (but for this subparagraph) be treated as financial services income under this paragraph.

The amount to which this paragraph does not apply by reason of the preceding sentence shall not exceed the interest or equivalent income of the controlled foreign corporation taken into account in determining financial services income without regard to this subparagraph.

(I) Look-thru applies to passive foreign investment company inclusion

If—

(i) a passive foreign investment company is a controlled foreign corporation, and

(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,

any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category.

(4) Look-thru applies to dividends from noncontrolled section 902 corporations

(A) In general

For purposes of this subsection, any dividend from a noncontrolled section 902 corporation with respect to the taxpayer shall be treated as income described in a subparagraph of paragraph (1) in proportion to the ratio of—

(i) the portion of earnings and profits attributable to income described in such subparagraph, to

(ii) the total amount of earnings and profits.

(B) Earnings and profits of controlled foreign corporations

In the case of any distribution from a controlled foreign corporation to a United States shareholder, rules similar to the rules of subparagraph (A) shall apply in determining the extent to which earnings and profits of the controlled foreign corporation which are attributable to dividends received from a noncontrolled section 902 corporation may be treated as income in a separate category.

(C) Special rules

For purposes of this paragraph—

(i) Earnings and profits

(I) In general The rules of section 316 shall apply.

(II) Regulations The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods before the taxpayer's acquisition of the stock to which the distributions relate.

(ii) Inadequate substantiation If the Secretary determines that the proper subparagraph of paragraph (1) in which a dividend is described has not been substantiated, such dividend shall be treated as income described in paragraph (1)(A).

(iii) Coordination with high-taxed income provisions Rules similar to the rules of paragraph (3)(F) shall apply for purposes of this paragraph.

(iv) Look-thru with respect to carryover of credit Rules similar to subparagraph (A) also shall apply to any carryforward under subsection (c) from a taxable year beginning before January 1, 2003, of tax allocable to a dividend from a noncontrolled section 902 corporation with respect to the taxpayer. The Secretary may by regulations provide for the allocation of any carryback of tax allocable to a dividend from a noncontrolled section 902 corporation from a taxable year beginning on or after January 1, 2003, to a taxable year beginning before such date for purposes of allocating such dividend among the separate categories in effect for the taxable year to which carried.

(5) Controlled foreign corporation; United States shareholder

For purposes of this subsection—

(A) Controlled foreign corporation

The term "controlled foreign corporation" has the meaning given such term by section 957 (taking into account section 953 (c)).

(B) United States shareholder

The term "United States shareholder" has the meaning given such term by section 951 (b) (taking into account section 953 (c)).

(6) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate for the purposes of this subsection, including regulations—

(A) for the application of paragraph (3) and subsection (f)(5) in the case of income paid (or loans made) through 1 or more entities or between 2 or more chains of entities,

(B) preventing the manipulation of the character of income the effect of which is to avoid the purposes of this subsection, and

(C) providing that rules similar to the rules of paragraph (3)(C) shall apply to interest, rents, and royalties received or accrued from entities which would be controlled foreign corporations if they were foreign corporations.

[(e) Repealed. Pub. L. 101–508, title XI, §•11801(a)(31), Nov. 5, 1990, 104 Stat. 1388–521]

(f) Recapture of overall foreign loss

(1) General rule

For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall foreign loss for any taxable year, that portion of the taxpayer’s taxable income from sources without the United States for each succeeding taxable year which is equal to the lesser of—

(A) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

(B) 50 percent (or such larger percent as the taxpayer may choose) of the taxpayer’s taxable income from sources without the United States for such succeeding taxable year,

shall be treated as income from sources within the United States (and not as income from sources without the United States).

(2) Overall foreign loss defined

For purposes of this subsection, the term “overall foreign loss” means the amount by which the gross income for the taxable year from sources without the United States (whether or not the taxpayer chooses the benefits of this subpart for such taxable year) for such year is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account—

(A) any net operating loss deduction allowable for such year under section 172 (a), and

(B) any—

(i) foreign expropriation loss for such year, as defined in section 172 (h) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990), or

(ii) loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft,

to the extent such loss is not compensated for by insurance or otherwise.

(3) Dispositions

(A) In general

For purposes of this chapter, if property which has been used predominantly without the United States in a trade or business is disposed of during any taxable year—

(i) the taxpayer, notwithstanding any other provision of this chapter (other than paragraph (1)), shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition, by reason of such disposition, in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer’s adjusted basis in such property or the remaining amount of the overall foreign losses which were not used under paragraph (1) for such taxable year or any prior taxable year, and

(ii) paragraph (1) shall be applied with respect to such income by substituting “100 percent” for “50 percent”.

In determining for purposes of this subparagraph whether the predominant use of any property has been without the United States, there shall be taken into account use during the 3-year period ending on the date of the disposition (or, if shorter, the period during which the property has been used in the trade or business).

(B) Disposition defined and special rules

(i) For purposes of this subsection, the term "disposition" includes a sale, exchange, distribution, or gift of property whether or not gain or loss is recognized on the transfer.

(ii) Any taxable income recognized solely by reason of subparagraph (A) shall have the same characterization it would have had if the taxpayer had sold or exchanged the property.

(iii) The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect taxable income recognized solely by reason of subparagraph (A).

(C) Exceptions

Notwithstanding subparagraph (B), the term "disposition" does not include—

(i) a disposition of property which is not a material factor in the realization of income by the taxpayer, or

(ii) a disposition of property to a domestic corporation in a distribution or transfer described in section 381 (a).

(D) Application to certain dispositions of stock in controlled foreign corporation

(i) In general This paragraph shall apply to an applicable disposition in the same manner as if it were a disposition of property described in subparagraph (A), except that the exception contained in subparagraph (C)(i) shall not apply.

(ii) Applicable disposition For purposes of clause (i), the term "applicable disposition" means any disposition of any share of stock in a controlled foreign corporation in a transaction or series of transactions if, immediately before such transaction or series of transactions, the taxpayer owned more than 50 percent (by vote or value) of the stock of the controlled foreign corporation. Such term shall not include a disposition described in clause (iii) or (iv), except that clause (i) shall apply to any gain recognized on any such disposition.

(iii) Exception for certain exchanges where ownership percentage retained A disposition shall not be treated as an applicable disposition under clause (ii) if it is part of a transaction or series of transactions—

(I) to which section 351 or 721 applies, or under which the transferor receives stock in a foreign corporation in exchange for the stock in the controlled foreign corporation and the stock received is exchanged basis property (as defined in section 7701 (a)(44)), and

(II) immediately after which, the transferor owns (by vote or value) at least the same percentage of stock in the controlled foreign corporation (or, if the controlled foreign corporation is not in existence after such transaction or series of transactions, in another foreign corporation stock in [2] which was received by the transferor in exchange for stock in the controlled foreign corporation) as the percentage of stock in the controlled foreign corporation which the taxpayer owned immediately before such transaction or series of transactions.

(iv) Exception for certain asset acquisitions A disposition shall not be treated as an applicable disposition under clause (ii) if it is part of a transaction or series of transactions in which the taxpayer (or any member of a controlled group of corporations filing a consolidated return under section 1501 which includes the taxpayer) acquires the assets of a controlled foreign corporation in exchange for the shares of the controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368 (a)(1).

(v) Controlled foreign corporation For purposes of this subparagraph, the term "controlled foreign corporation" has the meaning given such term by section 957.

(vi) Stock ownership For purposes of this subparagraph, ownership of stock shall be determined under the rules of subsections (a) and (b) of section 958.

(4) Accumulation distributions of foreign trust

For purposes of this chapter, in the case of amounts of income from sources without the United States which are treated under section 666 (without regard to subsections (b) and (c) thereof if the taxpayer chose to take a deduction with respect to the amounts described in such subsections under section 667 (d)(1)(B)) as having been distributed by a foreign trust in a preceding taxable year, that portion of such amounts equal to the amount of any overall foreign loss sustained by the beneficiary in a year prior to the taxable year of the beneficiary in which such distribution is received from the trust shall be treated as income from sources within the United States (and not income from sources without the United States) to the extent that such loss was not used under this subsection in prior taxable years, or in the current taxable year, against other income of the beneficiary.

(5) Treatment of separate limitation losses

(A) In general

The amount of the separate limitation losses for any taxable year shall reduce income from sources within the United States for such taxable year only to the extent the aggregate amount of such losses exceeds the aggregate amount of the separate limitation incomes for such taxable year.

(B) Allocation of losses

The separate limitation losses for any taxable year (to the extent such losses do not exceed the separate limitation incomes for such year) shall be allocated among (and operate to reduce) such incomes on a proportionate basis.

(C) Recharacterization of subsequent income

If—

(i) a separate limitation loss from any income category (hereinafter in this subparagraph referred to as "the loss category") was allocated to income from any other category under subparagraph (B), and

(ii) the loss category has income for a subsequent taxable year,

such income (to the extent it does not exceed the aggregate separate limitation losses from the loss category not previously recharacterized under this subparagraph) shall be recharacterized as income from such other category in proportion to the prior reductions under subparagraph (B) in such other category not previously taken into account under this subparagraph. Nothing in the preceding sentence shall be construed as recharacterizing any tax.

(D) Special rules for losses from sources in the United States

Any loss from sources in the United States for any taxable year (to the extent such loss does not exceed the separate limitation incomes from such year) shall be allocated among (and operate to reduce) such incomes on a proportionate basis. This subparagraph shall be applied after subparagraph (B).

(E) Definitions

For purposes of this paragraph—

(i) Income category The term "income category" means each separate category of income described in subsection (d)(1).

(ii) Separate limitation income The term "separate limitation income" means, with respect to any income category, the taxable income from sources outside the United States, separately computed for such category.

(iii) Separate limitation loss The term "separate limitation loss" means, with respect to any income category, the loss from such category determined under the principles of section 907 (c)(4)(B).

(F) Dispositions

If any separate limitation loss for any taxable year is allocated against any separate limitation income for such taxable year, except to the extent provided in regulations, rules similar to the rules of paragraph (3) shall apply to any disposition of property if gain from such disposition would be in the income category with respect to which there was such separate limitation loss.

(g) Source rules in case of United States-owned foreign corporations

(1) In general

The following amounts which are derived from a United States-owned foreign corporation and which would be treated as derived from sources outside the United States without regard to this subsection shall, for purposes of this section, be treated as derived from sources within the United States to the extent provided in this subsection:

(A) Any amount included in gross income under—

(i) section 951 (a) (relating to amounts included in gross income of United States shareholders), or

(ii) section 1293 (relating to current taxation of income from qualified funds).

(B) Interest.

(C) Dividends.

(2) Subpart F and passive foreign investment company inclusions

Any amount described in subparagraph (A) of paragraph (1) shall be treated as derived from sources within the United States to the extent such amount is attributable to income of the United States-owned foreign corporation from sources within the United States.

(3) Certain interest allocable to United States source income

Any interest which—

(A) is paid or accrued by a United States-owned foreign corporation during any taxable year,

(B) is paid or accrued to a United States shareholder (as defined in section 951 (b)) or a related person (within the meaning of section 267 (b)) to such a shareholder, and

(C) is properly allocable (under regulations prescribed by the Secretary) to income of such foreign corporation for the taxable year from sources within the United States,

shall be treated as derived from sources within the United States.

(4) Dividends

(A) In general

The United States source ratio of any dividend paid or accrued by a United States-owned foreign corporation shall be treated as derived from sources within the United States.

(B) United States source ratio

For purposes of subparagraph (A), the term "United States source ratio" means, with respect to any dividend paid out of the earnings and profits for any taxable year, a fraction—

(i) the numerator of which is the portion of the earnings and profits for such taxable year from sources within the United States, and

(ii) the denominator of which is the total amount of earnings and profits for such taxable year.

(5) Exception where United States-owned foreign corporation has small amount of United States source income

Paragraph (3) shall not apply to interest paid or accrued during any taxable year (and paragraph (4) shall not apply to any dividends paid out of the earnings and profits for such taxable year) if—

(A) the United States-owned foreign corporation has earnings and profits for such taxable year, and

(B) less than 10 percent of such earnings and profits is attributable to sources within the United States.

For purposes of the preceding sentence, earnings and profits shall be determined without any reduction for interest described in paragraph (3) (determined without regard to subparagraph (C) thereof).

(6) United States-owned foreign corporation

For purposes of this subsection, the term "United States-owned foreign corporation" means any foreign corporation if 50 percent or more of—

(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

(B) the total value of the stock of such corporation,

is held directly (or indirectly through applying paragraphs (2) and (3) of section 958 (a) and paragraph (4) of section 318 (a)) by United States persons (as defined in section 7701 (a)(30)).

(7) Dividend

For purposes of this subsection, the term "dividend" includes any gain treated as ordinary income under section 1246 [3] or as a dividend under section 1248.

(8) Coordination with subsection (f)

This subsection shall be applied before subsection (f).

(9) Treatment of certain domestic corporations

For purposes of this subsection—

(A) in the case of interest treated as not from sources within the United States under section 861 (a)(1)(A), the corporation paying such interest shall be treated as a United States-owned foreign corporation, and

(B) in the case of any dividend treated as not from sources within the United States under section 861 (a)(2)(A), the corporation paying such dividend shall be treated as a United States-owned foreign corporation.

(10) Coordination with treaties

(A) In general

If—

(i) any amount derived from a United States-owned foreign corporation would be treated as derived from sources within the United States under this subsection by reason of an item of income of such United States-owned foreign corporation,

(ii) under a treaty obligation of the United States (applied without regard to this subsection and by treating any amount included in gross income under section 951 (a)(1) as a dividend), such amount would be treated as arising from sources outside the United States, and

(iii) the taxpayer chooses the benefits of this paragraph,

this subsection shall not apply to such amount to the extent attributable to such item of income (but subsections (a), (b), and (c) of this section and sections 902, 907, and 960 shall be applied separately with respect to such amount to the extent so attributable).

(B) Special rule

Amounts included in gross income under section 951 (a)(1) shall be treated as a dividend under subparagraph (A)(ii) only if dividends paid by each corporation (the stock in which is taken into account in determining whether the shareholder is a United States shareholder in the United States-owned foreign corporation), if paid to the United States shareholder, would be treated under a treaty obligation of the United States as arising from sources outside the United States (applied without regard to this subsection).

(11) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate for purposes of this subsection, including—

(A) regulations for the application of this subsection in the case of interest or dividend payments through 1 or more entities, and

(B) regulations providing that this subsection shall apply to interest paid or accrued to any person (whether or not a United States shareholder).

(h) Coordination with nonrefundable personal credits

In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter (other than sections 23, 24, and 25B). This subsection shall not apply to taxable years beginning during 2000, 2001, 2002, 2003, 2004, or 2005.

(i) Limitation on use of deconsolidation to avoid foreign tax credit limitations

If 2 or more domestic corporations would be members of the same affiliated group if—

(1) section 1504 (b) were applied without regard to the exceptions contained therein, and

(2) the constructive ownership rules of section 1563 (e) applied for purposes of section 1504 (a),

the Secretary may by regulations provide for resourcing the income of any of such corporations or for modifications to the consolidated return regulations to the extent that such resourcing or modifications are necessary to prevent the avoidance of the provisions of this subpart.

(j) Certain individuals exempt

(1) In general

In the case of an individual to whom this subsection applies for any taxable year—

(A) the limitation of subsection (a) shall not apply,

(B) no taxes paid or accrued by the individual during such taxable year may be deemed paid or accrued under subsection (c) in any other taxable year, and

(C) no taxes paid or accrued by the individual during any other taxable year may be deemed paid or accrued under subsection (c) in such taxable year.

(2) Individuals to whom subsection applies

This subsection shall apply to an individual for any taxable year if—

(A) the entire amount of such individual's gross income for the taxable year from sources without the United States consists of qualified passive income,

(B) the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year does not exceed $300 ($600 in the case of a joint return), and

(C) such individual elects to have this subsection apply for the taxable year.

(3) Definitions

For purposes of this subsection—

(A) Qualified passive income

The term "qualified passive income" means any item of gross income if—

(i) such item of income is passive income (as defined in subsection (d)(2)(A) without regard to clause (iii) thereof), and

(ii) such item of income is shown on a payee statement furnished to the individual.

(B) Creditable foreign taxes

The term "creditable foreign taxes" means any taxes for which a credit is allowable under section 901; except that such term shall not include any tax unless such tax is shown on a payee statement furnished to such individual.

(C) Payee statement

The term "payee statement" has the meaning given to such term by section 6724 (d)(2).

(D) Estates and trusts not eligible

This subsection shall not apply to any estate or trust.

(k) Cross reference

(1) For increase of limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States shareholder with respect to a controlled foreign corporation, see section 960 (b).

(2) For modification of limitation under subsection (a) for purposes of determining the amount of credit which can be taken against the alternative minimum tax, see section 59 (a).

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[1] See References in Text note below.

[2] So in original.

[3] See References in Text note below.

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Sec. 871. - Tax on nonresident alien individuals

(a)

Income not connected with United States business - 30 percent tax

(1) Income other than capital gains

Except as provided in subsection (h), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as -

(A)

interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,

(B)

gains described in section 631(b) or (c), and gains on transfers described in section 1235 made on or before October 4, 1966,

(C)

in the case of -

(i)

a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and

(ii)

a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (except that such original issue discount shall be taken into account under this clause only to the extent such discount was not theretofore taken into account under this clause and only to the extent that the tax thereon does not exceed the payment less the tax imposed by subparagraph (A) thereon), and

(D)

gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

(2) Capital gains of aliens present in the United States 183 days or more

In the case of a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year, there is hereby imposed for such year a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from the sale or exchange at any time during such year of capital assets exceed his losses, allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets. For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such gains and losses were effectively connected with the conduct of a trade or business within the United States, except that such gains and losses shall be determined without regard to section 1202 and such losses shall be determined without the benefits of the capital loss carryover provided in section

1212. Any gain or loss which is taken into account in determining the tax under paragraph (1) or subsection (b) shall not be taken into account in determining the tax under this paragraph. For purposes of the 183-day requirement of this paragraph, a nonresident alien individual not engaged in trade or business within the United States who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

(3) Taxation of social security benefits

For purposes of this section and section 1441 -

(A)

85 percent of any social security benefit (as defined in section 86(d)) shall be included in gross income (notwithstanding section 207 of the Social Security Act), and

(B)

section 86 shall not apply.

For treatment of certain citizens of possessions of the United States, see section 932(c). [1]

(b)

Income connected with United States business - graduated rate of tax

(1) Imposition of tax

A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States.

(2) Determination of taxable income

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

(c) Participants in certain exchange or training programs

For purposes of this section, a nonresident alien individual who (without regard to this subsection) is not engaged in trade or business within the United States and who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J), (M), or (Q) of section 101(a)(15) of the Immigration and Nationality Act, as amended (8 U.S.C. 1101(a)(15)(F), (J), (M), or (Q)), shall be treated as a nonresident alien individual engaged in trade or business within the United States, and any income described in the second sentence of section 1441(b) which is received by such individual shall, to the extent derived from sources within the United States, be treated as effectively connected with the conduct of a trade or business within the United States.

(d) Election to treat real property income as income connected with United States business

(1) In general

A nonresident alien individual who during the taxable year derives any income -

(A)

from real property held for the production of income and located in the United States, or from any interest in such real property, including

(i)

gains from the sale or exchange of such real property or an interest therein,

(ii)

rents or royalties from mines, wells, or other natural deposits, and

(iii)

gains described in section 631(b) or (c), and

(B)

which, but for this subsection, would not be treated as income which is effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (b)(1) whether or not such individual is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year.

(2) Election after revocation

If an election has been made under paragraph (1) and such election has been revoked, a new election may not be made under such paragraph for any taxable year before the 5th taxable year which begins after the first taxable year for which such revocation is effective, unless the Secretary consents to such new election.

(3) Form and time of election and revocation

An election under paragraph (1), and any revocation of such an election, may be made only in such manner and at such time as the Secretary may by regulations prescribe.

(e)

Repealed. Pub. L. 99-514, title XII, Sec. 1211(b)(5), Oct. 22, 1986, 100 Stat. 2536)

(f) Certain annuities received under qualified plans

(1) In general

For purposes of this section, gross income does not include any amount received as an annuity under a qualified annuity plan described in section 403(a)(1), or from a qualified trust described in section 401(a) which is exempt from tax under section 501(a), if -

(A)

all of the personal services by reason of which the annuity is payable were either -

(i)

personal services performed outside the United States by an individual who, at the time of performance of such personal services, was a nonresident alien, or

(ii)

personal services described in section 864(b)(1) performed within the United States by such individual, and

(B)

at the time the first amount is paid as an annuity under the annuity plan or by the trust, 90 percent or more of the employees for whom contributions or benefits are provided under such annuity plan, or under the plan or plans of which the trust is a part, are citizens or residents of the United States.

(2) Exclusion

Income received during the taxable year which would be excluded from gross income under this subsection but for the requirement of paragraph (1)(B) shall not be included in gross income if -

(A)

the recipient's country of residence grants a substantially equivalent exclusion to residents and citizens of the United States; or

(B)

the recipient's country of residence is a beneficiary developing country under title V of the Trade Act of 1974 (19 U.S.C. 2461 et seq.).

(g) Special rules for original issue discount

For purposes of this section and section 881 -

(1) Original issue discount obligation

(A) In general

Except as provided in subparagraph (B), the term ''original issue discount obligation'' means any bond or other evidence of indebtedness having original issue discount (within the meaning of section 1273).

(B) Exceptions

The term ''original issue discount obligation'' shall not include -

(i) Certain short-term obligations

Any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

(ii) Tax-exempt obligations

Any obligation the interest on which is exempt from tax under section 103 or under any other provision of law without regard to the identity of the holder.

(2) Determination of portion of original issue discount accruing during any period

The determination of the amount of the original issue discount which accrues during any period shall be made under the rules of section 1272 (or the corresponding provisions of prior law) without regard to any exception for short-term obligations.

(3) Source of original issue discount

Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount described in subsection (a)(1)(C) is from sources within the United States shall be made at the time of the payment (or sale or exchange) as if such payment (or sale or exchange) involved the payment of interest.

(4) Stripped bonds

The provisions of section 1286 (relating to the treatment of stripped bonds and stripped coupons as obligations with original issue discount) shall apply for purposes of this section.

(h) Repeal of tax on interest of nonresident alien individuals received from certain portfolio debt investments

(1) In general

In the case of any portfolio interest received by a nonresident individual from sources within the United States, no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

(2) Portfolio interest

For purposes of this subsection, the term ''portfolio interest'' means any interest (including original issue discount) which would be subject to tax under subsection (a) but for this subsection and which is described in any of the following subparagraphs:

(A) Certain obligations which are not registered

Interest which is paid on any obligation which -

(i)

is not in registered form, and

(ii)

is described in section 163(f)(2)(B).

(B) Certain registered obligations

Interest which is paid on an obligation -

(i)

which is in registered form, and

(ii)

with respect to which the United States person who would otherwise be required to deduct and withhold tax from such interest under section 1441(a) receives a statement (which meets the requirements of paragraph (5)) that the beneficial owner of the obligation is not a United States person.

(3) Portfolio interest not to include interest received by 10-percent shareholders

For purposes of this subsection -

(A) In general

The term ''portfolio interest'' shall not include any interest described in subparagraph (A) or (B) of paragraph (2) which is received by a 10-percent shareholder.

(B) 10-Percent shareholder

The term ''10-percent shareholder'' means -

(i)

in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or

(ii)

in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

(C) Attribution rules

For purposes of determining ownership of stock under subparagraph (B)(i) the rules of section 318(a) shall apply, except that -

(i)

section 318(a)(2)(C) shall be applied without regard to the 50-percent limitation therein,

(ii)

section 318(a)(3)(C) shall be applied -

(I)

without regard to the 50-percent limitation therein; and

(II)

in any case where such section would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) which is owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owns in such corporation bears to the value of all stock in such corporation, and

(iii)

any stock which a person is treated as owning after application of section 318(a)(4) shall not, for purposes of applying paragraphs (2) and (3) of section 318(a), be treated as actually owned by such person.

Under regulations prescribed by the Secretary, rules similar to the rules of the preceding sentence shall be applied in determining the ownership of the capital or profits interest in a partnership for purposes of subparagraph (B)(ii).

(4) Portfolio interest not to include certain contingent interest

For purposes of this subsection -

(A) In general

Except as otherwise provided in this paragraph, the term ''portfolio interest'' shall not include -

(i)

any interest if the amount of such interest is determined by reference to -

(I)

any receipts, sales or other cash flow of the debtor or a related person,

(II)

any income or profits of the debtor or a related person,

(III)

any change in value of any property of the debtor or a related person, or

(IV)

any dividend, partnership distributions, or similar payments made by the debtor or a related person, or

(ii)

any other type of contingent interest that is identified by the Secretary by regulation, where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax.

(B) Related person

The term ''related person'' means any person who is related to the debtor within the meaning of section 267(b) or 707(b)(1), or who is a party to any arrangement undertaken for a purpose of avoiding the application of this paragraph.

(C) Exceptions

Subparagraph (A)(i) shall not apply to -

(i)

any amount of interest solely by reason of the fact that the timing of any interest or principal payment is subject to a contingency,

(ii)

any amount of interest solely by reason of the fact that the interest is paid with respect to nonrecourse or limited recourse indebtedness,

(iii)

any amount of interest all or substantially all of which is determined by reference to any other amount of interest not described in subparagraph (A) (or by reference to the principal amount of indebtedness on which such other interest is paid),

(iv)

any amount of interest solely by reason of the fact that the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to such interest,

(v)

any amount of interest determined by

reference to -

(I)

changes in the value of property (including stock) that is actively traded (within the meaning of section 1092(d)) other than property described in section 897(c)(1) or (g),

(II)

the yield on property described in subclause (I), other than a debt instrument that pays interest described in subparagraph (A), or stock or other property that represents a beneficial interest in the debtor or a related person, or

(III)

changes in any index of the value of property described in subclause (I) or of the yield on property described in subclause (II), and (vi) any other type of interest identified by the Secretary by regulation.

(D) Exception for certain existing indebtedness

Subparagraph (A) shall not apply to any interest paid or accrued with respect to any indebtedness with a fixed term -

(i)

which was issued on or before April 7, 1993, or

(ii)

which was issued after such date pursuant to a written binding contract in effect on such date and at all times thereafter before such indebtedness was issued.

(5) Certain statements

A statement with respect to any obligation meets the requirements of this paragraph if such statement is made by -

(A)

the beneficial owner of such obligation, or

(B)

a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business.

The preceding sentence shall not apply to any statement with respect to payment of interest on any obligation by any person if, at least one month before such payment, the Secretary has published a determination that any statement from such person (or any class including such person) does not meet the requirements of this paragraph.

(6) Secretary may provide subsection not to apply in cases of inadequate information exchange

(A) In general

If the Secretary determines that the exchange of information between the United States and a foreign country is inadequate to prevent evasion of the United States income tax by United States persons, the Secretary may provide in writing (and publish a statement) that the provisions of this subsection shall not apply to payments of interest to any person within such foreign country (or payments addressed to, or for the account of, persons within such foreign country) during the period -

(i)

beginning on the date specified by the Secretary, and

(ii)

ending on the date that the Secretary determines that the exchange of information between the United States and the foreign country is adequate to prevent the evasion of United States income tax by United States persons.

(B) Exception for certain obligations

Subparagraph (A) shall not apply to the payment of interest on any obligation which is issued on or before the date of the publication of the Secretary's determination under such subparagraph.

(7) Registered form

For purposes of this subsection, the term ''registered form'' has the same meaning given such term by section 163(f).

(i) Tax not to apply to certain interest and dividends

(1) In general

No tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a) on any amount described in paragraph (2).

(2) Amounts to which paragraph (1) applies

The amounts described in this paragraph are as follows:

(A)

Interest on deposits, if such interest is not effectively connected with the conduct of a trade or business within the United States.

(B)

A percentage of any dividend paid by a domestic corporation meeting the 80-percent foreign business requirements of section 861(c)(1) equal to the percentage determined for purposes of section 861(c)(2)(A).

(C)

Income derived by a foreign central bank of issue from bankers' acceptances.

(3) Deposits

For purposes of paragraph (2), the term

''deposits'' means amounts which are -

(A)

deposits with persons carrying on the banking business,

(B)

deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 (determined without regard to sections 265 and 291) in computing the taxable income of such institutions, and

(C)

amounts held by an insurance company under an agreement to pay interest thereon.

(j) Exemption for certain gambling winnings

No tax shall be imposed under paragraph (1)(A) of subsection (a) on the proceeds from a wager placed in any of the following games: blackjack, baccarat, craps, roulette, or big-6 wheel. The preceding sentence shall not apply in any case where the Secretary determines by regulation that the collection of the tax is administratively feasible.

(k)

Cross references

(1)

For tax treatment of certain amounts distributed by the United States to nonresident alien individuals, see section 402(e)(2).

(2)

For taxation of nonresident alien individuals who are expatriate United States citizens, see section 877.

(3)

For doubling of tax on citizens of certain foreign countries, see section 891.

(4)

For adjustment of tax in case of nationals or residents of certain foreign countries, see section 896.

(5)

For withholding of tax at source on nonresident alien individuals, see section 1441.

(6)

For election to treat married nonresident alien individual as resident of United States in certain cases, see subsections (g) and (h) of section 6013.

(7)

For special tax treatment of gain or loss from the disposition by a nonresident alien individual of a United States real property interest, see section 897

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[1] See References in Text note below.

Next

Sec. 882. - Tax on income of foreign corporations connected with United States business

(a) Imposition of tax

(1) In general

A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11, 55, 59A, or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

(2) Determination of taxable income

In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

(3)

(Cross reference [1])

For special tax treatment of gain or loss from the disposition by a foreign corporation of a United States real property interest, see section 897.

(b) Gross income

In the case of a foreign corporation, except where the context clearly indicates otherwise, gross income includes only -

(1)

gross 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, and

(2)

gross income which is effectively connected with the conduct of a trade or business within the United States.

(c) Allowance of deductions and credits

(1) Allocation of deductions

(A) General rule

In the case of a foreign corporation, the deductions shall be allowed only for purposes of subsection (a) and (except as provided by subparagraph (B)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary.

(B) Charitable contributions

The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income which is effectively connected with the conduct of a trade or business within the United States.

(2) Deductions and credits allowed only if return filed

A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits. The preceding sentence shall not apply for purposes of the tax imposed by section 541 (relating to personal holding company tax), and shall not be construed to deny the credit provided by section 33 for tax withheld at source or the credit provided by section 34 for certain uses of gasoline.

(3) Foreign tax credit

Except as provided by section 906, foreign corporations shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

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(4) Cross reference For rule that certain foreign taxes are not to be taken into

Topical references

For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906(b)(1).

(d) Election to treat real property income as income connected with United States business

(1) In general

A foreign corporation which during the taxable year derives any income -

(A)

from real property located in the United States, or from any interest in such real property, including

(i)

gains from the sale or exchange of real property or an interest therein,

(ii)

rents or royalties from mines, wells, or other natural deposits, and

(iii)

gains described in section 631(b) or (c), and

(B)

which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary with respect to any taxable year.

(2) Election after revocation, etc.

Paragraphs (2) and (3) of section 871(d) shall apply in respect of elections under this subsection in the same manner and to the same extent as they apply in respect of elections under section 871(d).

(e) Interest on United States obligations received by banks organized in possessions

In the case of a corporation created or organized in, or under the law of, a possession of the United States which is carrying on the banking business in a possession of the United States, interest on obligations of the United States which is not portfolio interest (as defined in section 881(c)(2)) shall -

(1)

for purposes of this subpart, be treated as income which is effectively connected with the conduct of a trade or business within the United States, and

(2)

shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year.

(f) Returns of tax by agent

If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent

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[1] Par. (3) heading editorially supplied.

§ 901. Taxes of foreign countries and of possessions of United States

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(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26 (b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico

In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations

In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates

In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672 (f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents

Whenever the President finds that—

(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC

For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992 (a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income

(1) Reduction in amount allowed

Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which—

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B) the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined

For purposes of paragraph (1), the term "foreign mineral income" means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to—

(A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B) that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes

Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275 (a) and this section if—

(1) the taxpayer has no economic interest in the oil or gas to which section 611 (a) applies, and

(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations

(1) In general

For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation—

(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)

(i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized, shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation

For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957 (c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

(h) Taxes paid with respect to foreign trade income

No credit shall be allowed under this section for any income, war profits, and excess profits taxes paid or accrued with respect to the foreign trade income (within the meaning of section 923(b)) [1] of a FSC, other than section 923 (a)(2) [1] non-exempt income (within the meaning of section 927 (d)(6)).[1]

(i) Taxes used to provide subsidies

Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries

(1) In general

Notwithstanding any other provision of this part—

(A) no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B) subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies

(A) In general

This subsection shall apply to any foreign country—

(i) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii) with respect to which the United States has severed diplomatic relations,

(iii) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies

This subsection shall apply to any foreign country described in subparagraph (A) during the period—

(i) beginning on the later of—

(I) January 1, 1987, or

(II) 6 months after such country becomes a country described in subparagraph (A), and

(ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial

(A) In general

Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President—

(i) determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii) reports such waiver under subparagraph (B).

(B) Report

Not less than 30 days before the date on which a waiver is granted under this paragraph, the President shall report to Congress—

(i) the intention to grant such waiver; and

(ii) the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes on dividends

(1) Withholding taxes

(A) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if —

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend 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.

(B) Withholding tax

For purposes of this paragraph, the term "withholding tax" includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes

In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if—

(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends

In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied —

(A) by substituting "45 days" for "15 days" each place it appears, and

(B) by substituting "91-day period" for "31-day period".

(4) Exception for certain taxes paid by securities dealers

(A) In general

Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a business as a securities dealer of any person—

(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or

(iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a securities regulating authority of such country.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply

For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246 (c) shall apply.

(6) Treatment of bona fide sales

If a person's holding period is reduced by reason of the application of the rules of section 246 (c)(4) to any contract for the bona fide sale of stock, the determination of whether such person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(l) Minimum holding period for withholding taxes on gain and income other than dividends etc.

(1) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if—

(A) such property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item 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.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) Exception for taxes paid by dealers

(A) In general

Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) Qualified tax

For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Dealer

For purposes of subparagraph (A), the term "dealer" means—

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof if such security were stock, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221 (a)(1).

(D) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) Exceptions

The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) Certain rules to apply

Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) Determination of holding period

Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

(m) Cross reference

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703 (b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642 (a).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038.

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[1] See References in Text note below.

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Sec. 904. - Limitation on credit

(a) Limitation

The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) Taxable income for purpose of computing limitation

(1) Personal exemptions

For purposes of subsection (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b).

(2) Capital gains

For purposes of this section -

(A) In general

Taxable income from sources outside the United States shall include gain from the sale or exchange of capital assets only to the extent of foreign source capital gain net income.

(B) Special rules where capital gain rate differential

In the case of any taxable year for which there is a capital gain rate differential -

(i)

in lieu of applying subparagraph (A), the taxable income from sources outside the United States shall include gain from the sale or exchange of capital assets only in an amount equal to foreign source capital gain net income reduced by the rate differential portion of foreign source net capital gain,

(ii)

the entire taxable income shall include gain from the sale or exchange of capital assets only in an amount equal to capital gain net income reduced by the rate differential portion of net capital gain, and

(iii)

for purposes of determining taxable income from sources outside the United States, any net capital loss (and any amount which is a short-term capital loss under section 1212(a)) from sources outside the United States to the extent taken into account in determining capital gain net income for the taxable year shall be reduced by an amount equal to the rate differential portion of the excess of net capital gain from sources within the United States over net capital gain.

(C) Coordination with capital gains rates

The Secretary may by regulations modify the application of this paragraph and paragraph (3) to the extent necessary to properly reflect any capital gain rate differential under section 1(h) or 1201(a) and the computation of net capital gain.

(3) Definitions

For purposes of this subsection -

(A) Foreign source capital gain net income

The term ''foreign source capital gain net income'' means the lesser of -

(i)

capital gain net income from sources without the United States, or

(ii)

capital gain net income.

(B) Foreign source net capital gain

The term ''foreign source net capital gain'' means the lesser of -

(i)

net capital gain from sources without the United States, or

(ii)

net capital gain.

(C) Section 1231 gains

The term ''gain from the sale or exchange of capital assets'' includes any gain so treated under section 1231.

(D) Capital gain rate differential

There is a capital gain rate differential for any taxable year if -

(i)

in the case of a taxpayer other than a corporation, subsection (h) of section 1 applies to such taxable year, or

(ii)

in the case of a corporation, any rate of tax imposed by section 11, 511, or 831(a) or (b) (whichever applies) exceeds the alternative rate of tax under section 1201(a) (determined without regard to the last sentence of section 11(b)(1)).

(E) Rate differential portion

(i) In general

The rate differential portion of foreign source net capital gain, net capital gain, or the excess of net capital gain from sources within the United States over net capital gain, as the case may be, is the same proportion of such amount as -

(I)

the excess of the highest applicable tax rate over the alternative tax rate, bears to

(II)

the highest applicable tax rate.

(ii) Highest applicable tax rate

For purposes of clause (i), the term ''highest applicable tax rate'' means -

(I)

in the case of a taxpayer other than a corporation, the highest rate of tax set forth in subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies), or

(II)

in the case of a corporation, the highest rate of tax specified in section 11(b).

(iii) Alternative tax rate

For purposes of clause (i), the term ''alternative tax rate'' means -

(I)

in the case of a taxpayer other than a corporation, the alternative rate of tax determined under section 1(h), or

(II)

in the case of a corporation, the alternative rate of tax under section 1201(a).

(4) Coordination with section 936

For purposes of subsection (a), in the case of a corporation, the taxable income shall not include any portion thereof taken into account for purposes of the credit (if any) allowed by section 936 (without regard to subsections (a)(4) and (i) thereof).

(c) Carryback and carryover of excess tax paid

Any amount by which all taxes paid or accrued to foreign countries or possessions of the United States for any taxable year for which the taxpayer chooses to have the benefits of this subpart exceed the limitation under subsection (a) shall be deemed taxes paid or accrued to foreign countries or possessions of the United States in the second preceding taxable year, in the first preceding taxable year, and in the first, second, third, fourth, or fifth succeeding taxable years, in that order and to the extent not deemed taxes paid or accrued in a prior taxable year, in the amount by which the limitation under subsection (a) for such preceding or succeeding taxable year exceeds the sum of the taxes paid or accrued to foreign countries or possessions of the United States for such preceding or succeeding taxable year and the amount of the taxes for any taxable year earlier than the current taxable year which shall be deemed to have been paid or accrued in such preceding or subsequent taxable year (whether or not the taxpayer chooses to have the benefits of this subpart with respect to such earlier taxable year). Such amount deemed paid or accrued in any year may be availed of only as a tax credit and not as a deduction and only if the taxpayer for such year chooses to have the benefits of this subpart as to taxes paid or accrued for that year to foreign countries or possessions of the United States.

(d) Separate application of section with respect to certain categories of income

(1) In general

The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to each of the following items of income:

(A)

passive income,

(B)

high withholding tax interest,

(C)

financial services income,

(D)

shipping income,

(E)

in the case of a corporation, dividends from each noncontrolled section 902 corporation,

(F)

dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States,

(G)

taxable income attributable to foreign trade income (within the meaning of section 923(b)), [1]

(H)

distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) [1] or interest or carrying charges (as defined in section 927(d)(1)) (FOOTNOTE 1) derived from a transaction which results in foreign trade income (as defined in section 923(b)) (FOOTNOTE 1) , and

(I)

income other than income described in

any of the preceding subparagraphs.

(2) Definitions and special rules

For purposes of this subsection -

(A) Passive income

(i) In general

Except as otherwise provided in this subparagraph, the term ''passive income'' means any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as defined in section 954(c)).

(ii) Certain amounts included

Except as provided in clause (iii), the term ''passive income'' includes any amount includible in gross income under section 551 or, except as provided in subparagraph (E)(iii) or paragraph (3)(I), section 1293 (relating to certain passive foreign investment companies).

(iii) Exceptions

The term ''passive income'' shall not include -

(I)

any income described in a subparagraph of paragraph (1) other than subparagraph (A),

(II)

any export financing interest, and

(III)

any high-taxed income.

(iv) Clarification of application of section 864(d)(6)

In determining whether any income is of a kind which would be foreign personal holding company income, the rules of section 864(d)(6) shall apply only in the case of income of a controlled foreign corporation.

(B) High withholding tax interest

(i) In general

Except as otherwise provided in this subparagraph, the term ''high withholding tax interest'' means any interest if -

(I)

such interest is subject to a withholding tax of a foreign country or possession of the United States (or other tax determined on a gross basis), and

(II)

the rate of such tax applicable to such interest is at least 5 percent.

(ii) Exception for export financing

The term ''high withholding tax interest'' shall not include any export financing interest.

(iii) Regulations

The Secretary may by regulations provide that -

(I)

amounts (not otherwise high withholding tax interest) shall be treated as high withholding tax interest where necessary to prevent avoidance of the purposes of this subparagraph, and

(II)

a tax shall not be treated as a withholding tax or other tax imposed on a gross basis if such tax is in the nature of a prepayment of a tax imposed on a net basis.

(C) Financial services income

(i) In general

Except as otherwise provided in this subparagraph, the term ''financial services income'' means any income which is received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, and which is -

(I)

described in clause (ii),

(II)

passive income (determined without regard to subclauses (I) and (III) of subparagraph (A)(iii)), or

(III)

export financing interest which (but for subparagraph (B)(ii)) would be high withholding tax interest.

(ii) General description of financial services income

Income is described in this clause if such income is -

(I)

derived in the active conduct of a banking, financing, or similar business,

(II)

derived from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, or

(III)

of a kind which would be insurance

income as defined in section 953(a) determined without regard to those provisions of paragraph (1)(A) of such section which limit insurance income to income from countries other than the country in which the corporation was created or organized.

(iii) Exceptions

The term ''financial services income'' does not include -

(I)

any high withholding tax interest,

(II)

any dividend from a noncontrolled section 902 corporation, and

(III)

any export financing interest not described in clause (i)(III).

(D) Shipping income

The term ''shipping income'' means any income received or accrued by any person which is of a kind which would be foreign base company shipping income (as defined in section 954(f)). Such term does not include any dividend from a noncontrolled section 902 corporation and does not include any financial services income.

(E) Noncontrolled section 902 corporation

(i) In general

The term ''noncontrolled section 902 corporation'' means any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a) (or, for purposes of applying paragraph (3), the requirements of section 902(b)). A controlled foreign corporation shall not be treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation.

(ii) Special rule for taxes on high-withholding tax interest

If a foreign corporation is a noncontrolled section 902 corporation with respect to the taxpayer, taxes on high withholding tax interest (to the extent imposed at a rate in excess of 5 percent) shall not be treated as foreign taxes for purposes of determining the amount of foreign taxes deemed paid by the taxpayer under section 902.

(iii) Treatment of inclusions under section 1293

If any foreign corporation is a non-controlled section 902 corporation with respect to the taxpayer, any inclusion under section 1293 with respect to such corporation shall be treated as a dividend from such corporation.

(F) High-taxed income

The term ''high-taxed income'' means any income which (but for this subparagraph) would be passive income if the sum of -

(i)

the foreign income taxes paid or accrued by the taxpayer with respect to such income, and

(ii)

the foreign income taxes deemed paid by the taxpayer with respect to such income under section 902 or 960,

exceeds the highest rate of tax specified in section 1 or 11 (whichever applies) multiplied by the amount of such income (determined with regard to section 78). For purposes of the preceding sentence, the term ''foreign income taxes'' means any income, war profits, or excess profits tax imposed by any foreign country or possession of the United States.

(G) Export financing interest

For purposes of this paragraph, the term ''export financing interest'' means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property -

(i)

which is manufactured, produced,

grown, or extracted in the United States by the taxpayer or a related person, and

(ii)

not more than 50 percent of the fair market value of which is attributable to products imported into the United States.

For purposes of clause (ii), the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.

(H) Related person

For purposes of this paragraph, the term ''related person'' has the meaning given such term by section 954(d)(3), except that such section shall be applied by substituting ''the person with respect to whom the determination is being made'' for ''controlled foreign corporation'' each place it appears.

(I) Transitional rule

For purposes of paragraph (1) -

(i)

taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income which was described in subparagraph (A) of paragraph (1) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) shall be treated as taxes paid or accrued with respect to income described in subparagraph (A) of paragraph (1) (as in effect after such date),

(ii)

taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income which was described in subparagraph (E) of paragraph (1) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) shall be treated as taxes paid or accrued with respect to income described in subparagraph (I) of paragraph (1) (as in effect after such date) except that -

(I)

such taxes shall be treated as paid or accrued with respect to shipping income to the extent the taxpayer establishes to the satisfaction of the Secretary that such taxes were paid or accrued with respect to such income,

(II)

in the case of a person described in subparagraph (C)(i), such taxes shall be treated as paid or accrued with respect to financial services income to the extent the taxpayer establishes to the satisfaction of the

Secretary that such taxes were paid or accrued with respect to such income, and

(III)

such taxes shall be treated as paid or accrued with respect to high withholding tax interest to the extent the taxpayer establishes to the satisfaction of the Secretary that such taxes were paid or accrued with respect to such income, and

(iii)

taxes paid or accrued in a taxable year beginning before January 1, 1987, with respect to income described in any other subparagraph of paragraph (1) (as so in effect before such date) shall be treated as taxes paid or accrued with respect to income described in the corresponding subparagraph of paragraph (1) (as so in effect after such date).

(3) Look-thru in case of controlled foreign corporations

(A) In general

Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as income in a separate category.

(B) Subpart F inclusions

Any amount included in gross income under section 951(a)(1)(A) shall be treated as income in a separate category to the extent the amount so included is attributable to income in such category.

(C) Interest, rents, and royalties

Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category to the extent it is properly allocable (under regulations prescribed by the Secretary) to income of the controlled foreign corporation in such category.

(D) Dividends

Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as income in a separate category in proportion to the ratio of -

(i)

the portion of the earnings and profits attributable to income in such category, to

(ii)

the total amount of earnings and profits.

(E) Look-thru applies only where subpart F applies

If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as income in a separate category, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as income in a separate category if the requirements of section 954(b)(4) are met with respect to such income.

(F) Separate category

For purposes of this paragraph -

(i) In general

Except as provided in clause (ii), the term ''separate category'' means any category of income described in subparagraph (A), (B), (C), (D), or (E) of paragraph (1).

(ii) Coordination with high-taxed income provisions

(I)

In determining whether any income of a controlled foreign corporation is in a separate category, subclause (III) of paragraph (2)(A)(iii) shall not apply.

(II)

Any income of the taxpayer which is treated as income in a separate category under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

(G) Dividend

For purposes of this paragraph, the term ''dividend'' includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

(H) Exception for certain high withholding tax interest

This paragraph shall not apply to any amount which -

(i)

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without regard to this paragraph, is high withholding tax interest (including any amount treated as high withholding tax interest under paragraph (2)(B)(iii)), and

(ii)

would (but for this subparagraph) be treated as financial services income under this paragraph.

The amount to which this paragraph does not apply by reason of the preceding sentence shall not exceed the interest or equivalent income of the controlled foreign corporation taken into account in determining financial services income without regard to this subparagraph.

(I) Look-thru applies to passive foreign investment company inclusion

If -

(i)

a passive foreign investment company is a controlled foreign corporation, and

(ii)

the taxpayer is a United States shareholder in such controlled foreign corporation,

any amount included in gross income under section 1293 shall be treated as income in a separate category to the extent such amount is attributable to income in such category.

(4) Controlled foreign corporation; United States shareholder

For purposes of this subsection -

(A) Controlled foreign corporation

The term ''controlled foreign corporation'' has the meaning given such term by section 957 (taking into account section 953(c)).

(B) United States shareholder

The term ''United States shareholder'' has the meaning given such term by section 951(b) (taking into account section 953(c)).

(5) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate for the purposes of this subsection, including regulations -

(A)

for the application of paragraph (3) and subsection (f)(5) in the case of income paid (or loans made) through 1 or more entities or between 2 or more chains of entities,

(B)

preventing the manipulation of the

character of income the effect of which is to avoid the purposes of this subsection, and

(C)

providing that rules similar to the rules of paragraph (3)(C) shall apply to interest, rents, and royalties received or accrued from entities which would be controlled foreign corporations if they were foreign corporations.

(e)

Repealed. Pub. L. 101-508, title XI, Sec. 11801(a)(31), Nov. 5, 1990, 104 Stat. 1388-521)

(f) Recapture of overall foreign loss

(1) General rule

For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall foreign loss for any taxable year, that portion of the taxpayer's taxable income from sources without the United States for each succeeding taxable year which is equal to the lesser of -

(A)

the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

(B)

50 percent (or such larger percent as the

taxpayer may choose) of the taxpayer's taxable income from sources without the United States for such succeeding taxable year,

shall be treated as income from sources within the United States (and not as income from sources without the United States).

(2) Overall foreign loss defined

For purposes of this subsection, the term ''overall foreign loss'' means the amount by which the gross income for the taxable year from sources without the United States (whether or not the taxpayer chooses the benefits of this subpart for such taxable year) for such year is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account -

(A)

any net operating loss deduction allowable for such year under section 172(a), and

(B)

any -

(i)

foreign expropriation loss for such year, as defined in section 172(h) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990), or

(ii)

loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft, to the extent such loss is not compensated for by insurance or otherwise.

(3) Dispositions

(A) In general

For purposes of this chapter, if property which has been used predominantly without the United States in a trade or business is disposed of during any taxable year -

(i)

the taxpayer, notwithstanding any other provision of this chapter (other than paragraph (1)), shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition, by reason of such disposition, in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of the overall foreign losses which were not used under paragraph (1) for such taxable year or any prior taxable year, and

(ii)

paragraph (1) shall be applied with

respect to such income by substituting ''100 percent'' for ''50 percent''.

In determining for purposes of this subparagraph whether the predominant use of any property has been without the United States, there shall be taken into account use during the 3-year period ending on the date of the disposition (or, if shorter, the period during which the property has been used in the trade or business).

(B) Disposition defined and special rules

(i)

For purposes of this subsection, the term ''disposition'' includes a sale, exchange, distribution, or gift of property whether or not gain or loss is recognized on the transfer.

(ii)

Any taxable income recognized solely by reason of subparagraph (A) shall have the same characterization it would have had if the taxpayer had sold or exchanged the property.

(iii)

The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect taxable income recognized solely by reason of subparagraph (A).

(C) Exceptions

Notwithstanding subparagraph (B), the term ''disposition'' does not include -

(i)

a disposition of property which is not a material factor in the realization of income by the taxpayer, or

(ii)

a disposition of property to a domestic corporation in a distribution or transfer described in section 381(a).

(4) Accumulation distributions of foreign trust

For purposes of this chapter, in the case of amounts of income from sources without the United States which are treated under section 666 (without regard to subsections (b) and (c) thereof if the taxpayer chose to take a deduction with respect to the amounts described in such subsections under section 667(d)(1)(B)) as having been distributed by a foreign trust in a preceding taxable year, that portion of such amounts equal to the amount of any overall foreign loss sustained by the beneficiary in a year prior to the taxable year of the beneficiary in which such distribution is received from the trust shall be treated as income from sources within the United States (and not income from sources without the United States) to the extent that such loss was not used under this subsection in prior taxable years, or in the current taxable year, against other income of the beneficiary.

(5) Treatment of separate limitation losses

(A) In general

The amount of the separate limitation losses for any taxable year shall reduce income from sources within the United States for such taxable year only to the extent the aggregate amount of such losses exceeds the aggregate amount of the separate limitation incomes for such taxable year.

(B) Allocation of losses

The separate limitation losses for any taxable year (to the extent such losses do not exceed the separate limitation incomes for such year) shall be allocated among (and operate to reduce) such incomes on a proportionate basis.

(C) Recharacterization of subsequent income

If -

(i)

a separate limitation loss from any income category (hereinafter in this subparagraph referred to as ''the loss category'') was allocated to income from any other category under subparagraph (B), and

(ii)

the loss category has income for a subsequent taxable year, such income (to the extent it does not exceed the aggregate separate limitation losses from the loss category not previously recharacterized under this subparagraph) shall be recharacterized as income from such other category in proportion to the prior reductions under subparagraph (B) in such other category not previously taken into account under this subparagraph. Nothing in the preceding sentence shall be construed as recharacterizing any tax.

(D) Special rules for losses from sources in the United States

Any loss from sources in the United States for any taxable year (to the extent such loss does not exceed the separate limitation incomes from such year) shall be allocated among (and operate to reduce) such incomes on a proportionate basis. This subparagraph shall be applied after subparagraph (B).

(E) Definitions

For purposes of this paragraph -

(i) Income category

The term ''income category'' means each separate category of income described in subsection (d)(1).

(ii) Separate limitation income

The term ''separate limitation income'' means, with respect to any income category, the taxable income from sources outside the United States, separately computed for such category.

(iii) Separate limitation loss

The term ''separate limitation loss'' means, with respect to any income category, the loss from such category determined under the principles of section 907(c)(4)(B).

(F) Dispositions

If any separate limitation loss for any taxable year is allocated against any separate limitation income for such taxable year, except to the extent provided in regulations, rules similar to the rules of paragraph (3) shall apply to any disposition of property if gain from such disposition would be in the income category with respect to which there was such separate limitation loss.

(g) Source rules in case of United States-owned foreign corporations

(1) In general

The following amounts which are derived from a United States-owned foreign corporation and which would be treated as derived from sources outside the United States without regard to this subsection shall, for purposes of this section, be treated as derived from sources within the United States to the extent provided in this subsection:

(A)

Any amount included in gross income under -

(i)

section 951(a) (relating to amounts included in gross income of United States shareholders),

(ii)

section 551 (relating to foreign personal holding company income taxed to United States shareholders), or

(iii)

section 1293 (relating to current taxation of income from qualified funds).

(B)

Interest.

(C)

Dividends.

(2) Subpart F and foreign personal holding or passive foreign investment company inclusions

Any amount described in subparagraph (A) of paragraph (1) shall be treated as derived from sources within the United States to the extent such amount is attributable to income of the United States-owned foreign corporation from sources within the United States.

(3) Certain interest allocable to United States source income

Any interest which -

(A)

is paid or accrued by a United States-owned foreign corporation during any taxable year,

(B)

is paid or accrued to a United States shareholder (as defined in section 951(b)) or a related person (within the meaning of section 267(b)) to such a shareholder, and

(C)

is properly allocable (under regulations prescribed by the Secretary) to income of such foreign corporation for the taxable year from sources within the United States,

shall be treated as derived from sources within the United States.

(4) Dividends

(A) In general

The United States source ratio of any dividend paid or accrued by a United States-owned foreign corporation shall be treated as derived from sources within the United States.

(B) United States source ratio

For purposes of subparagraph (A), the term ''United States source ratio'' means, with respect to any dividend paid out of the earnings and profits for any taxable year, a fraction -

(i)

the numerator of which is the portion of the earnings and profits for such taxable year from sources within the United States, and

(ii)

the denominator of which is the total amount of earnings and profits for such taxable year.

(5) Exception where United States-owned foreign corporation has small amount of United States source income

Paragraph (3) shall not apply to interest paid or accrued during any taxable year (and paragraph (4) shall not apply to any dividends paid out of the earnings and profits for such taxable year) if -

(A)

the United States-owned foreign corporation has earnings and profits for such taxable year, and

(B)

less than 10 percent of such earnings and profits is attributable to sources within the United States.

For purposes of the preceding sentence, earnings and profits shall be determined without any reduction for interest described in paragraph (3) (determined without regard to subparagraph (C) thereof).

(6) United States-owned foreign corporation

For purposes of this subsection, the term ''United States-owned foreign corporation'' means any foreign corporation if 50 percent or more of -

(A)

the total combined voting power of all classes of stock of such corporation entitled to vote, or

(B)

the total value of the stock of such corporation,

is held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30)).

(7) Dividend

For purposes of this subsection, the term ''dividend'' includes any gain treated as ordinary income under section 1246 or as a dividend under section 1248.

(8) Coordination with subsection (f)

This subsection shall be applied before subsection (f).

(9) Treatment of certain domestic corporations

For purposes of this subsection -

(A)

in the case of interest treated as not from sources within the United States under section 861(a)(1)(A), the corporation paying such interest shall be treated as a United States-owned foreign corporation, and

(B)

in the case of any dividend treated as not from sources within the United States under section 861(a)(2)(A), the corporation paying such dividend shall be treated as a United States-owned foreign corporation.

(10) Coordination with treaties

(A) In general

If -

(i)

any amount derived from a United

States-owned foreign corporation would be treated as derived from sources within the United States under this subsection by reason of an item of income of such United States-owned foreign corporation,

(ii)

under a treaty obligation of the United States (applied without regard to this subsection and by treating any amount included in gross income under section 951(a)(1) as a dividend), such amount would be treated as arising from sources outside the United States, and

(iii)

the taxpayer chooses the benefits of this paragraph,

this subsection shall not apply to such amount to the extent attributable to such item of income (but subsections (a), (b), and (c) of this section and sections 902, 907, and 960 shall be applied separately with respect to such amount to the extent so attributable).

(B) Special rule

Amounts included in gross income under section 951(a)(1) shall be treated as a dividend under subparagraph (A)(ii) only if dividends paid by each corporation (the stock in which is taken into account in determining whether the shareholder is a United States shareholder in the United States-owned foreign corporation), if paid to the United States shareholder, would be treated under a treaty obligation of the United States as arising from sources outside the United States (applied without regard to this subsection).

(11) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate for purposes of this subsection, including -

(A)

regulations for the application of this subsection in the case of interest or dividend payments through 1 or more entities, and

(B)

regulations providing that this subsection shall apply to interest paid or accrued to any person (whether or not a United States shareholder).

(h) Coordination with nonrefundable personal credits

In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter. This subsection shall not apply to taxable years beginning during 2000 or 2001.

(i) Limitation on use of deconsolidation to avoid foreign tax credit limitations

If 2 or more domestic corporations would be members of the same affiliated group if -

(1)

section 1504(b) were applied without regard to the exceptions contained therein, and

(2)

the constructive ownership rules of section 1563(e) applied for purposes of section 1504(a),

the Secretary may by regulations provide for resourcing the income of any of such corporations or for modifications to the consolidated return regulations to the extent that such resourcing or modifications are necessary to prevent the avoidance of the provisions of this subpart.

(j) Certain individuals exempt

(1) In general

In the case of an individual to whom this subsection applies for any taxable year -

(A)

the limitation of subsection (a) shall not apply,

(B)

no taxes paid or accrued by the individual during such taxable year may be deemed paid or accrued under subsection (c) in any other taxable year, and

(C)

no taxes paid or accrued by the individual during any other taxable year may be deemed paid or accrued under subsection (c) in such taxable year.

(2) Individuals to whom subsection applies

This subsection shall apply to an individual for any taxable year if -

(A)

the entire amount of such individual's gross income for the taxable year from sources without the United States consists of qualified passive income,

(B)

the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year does not exceed $300 ($600 in the case of a joint return), and

(C)

such individual elects to have this subsection apply for the taxable year.

(3) Definitions

For purposes of this subsection -

(A) Qualified passive income

The term ''qualified passive income''

means any item of gross income if -

(i)

such item of income is passive income (as defined in subsection (d)(2)(A) without regard to clause (iii) thereof), and

(ii)

such item of income is shown on a payee statement furnished to the individual.

(B) Creditable foreign taxes

The term ''creditable foreign taxes'' means any taxes for which a credit is allowable under section 901; except that such term shall not include any tax unless such tax is shown on a payee statement furnished to such individual.

(C) Payee statement

The term ''payee statement'' has the meaning given to such term by section 6724(d)(2).

(D) Estates and trusts not eligible

This subsection shall not apply to any estate or trust.

(k)

Cross reference

(1)

For increase of limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States shareholder with respect to a controlled foreign corporation, see section 960(b).

(2)

For modification of limitation under subsection (a) for purposes of determining the amount of credit which can be taken against the alternative minimum tax, see section 59(a)

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[1] See References in Text note below.

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Sec. 901. - Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico

In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations

In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates

In the case of any individual described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents

Whenever the President finds that -

(1)

a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2)

such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3)

it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United

States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC

For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income

(1) Reduction in amount allowed

Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which -

(A)

the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B)

the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined

For purposes of paragraph (1), the term ''foreign mineral income'' means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to -

(A)

dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B)

that portion of the taxpayer's distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes

Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if -

(1)

the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and

(2)

either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations

(1) In general

For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation -

(A)

to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)

(i)

if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii)

to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized,

shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation

For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

(h) Taxes paid with respect to foreign trade income

No credit shall be allowed under this section for any income, war profits, and excess profits taxes paid or accrued with respect to the foreign trade income (within the meaning of section 923(b)) [1] of a FSC, other than section 923(a)(2) (FOOTNOTE 1) non-exempt income (within the meaning of section 927(d)(6)). (FOOTNOTE 1)

(i) Taxes used to provide subsidies

Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent -

(1)

the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2)

such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries

(1) In general

Notwithstanding any other provision of this part -

(A)

no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B)

subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies

(A) In general

This subsection shall apply to any foreign country -

(i)

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the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii)

with respect to which the United States has severed diplomatic relations,

(iii)

with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv)

which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies

This subsection shall apply to any foreign country described in subparagraph (A) during the period -

(i)

beginning on the later of -

(I)

January 1, 1987, or

(II)

6 months after such country becomes a country described in subparagraph (A), and (ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial

(A) In general

Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President -

(i)

determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii)

reports such waiver under subparagraph (B).

(B) Report

Not less than 30 days before the date on which a waiver is granted under this paragraph, the President shall report to Congress -

(i)

the intention to grant such waiver; and

(ii)

the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes

(1) Withholding taxes

(A) In general

In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if -

(i)

such stock is held by the recipient of the dividend for 15 days or less during the 30-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii)

to the extent that the recipient of the dividend 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.

(B) Withholding tax

For purposes of this paragraph, the term ''withholding tax'' includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes

In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if -

(A)

any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B)

the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends

In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied -

(A)

by substituting ''45 days'' for ''15 days'' each place it appears, and

(B)

by substituting ''90-day period'' for ''30-day period''.

(4) Exception for certain taxes paid by securities dealers

(A) In general

Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a business as a securities dealer of any person -

(i)

who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii)

who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or

(iii)

who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a securities regulating authority of such country.

(B) Qualified tax

For purposes of subparagraph (A), the term ''qualified tax'' means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if -

(i)

the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii)

such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations

The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply

For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

(6) Treatment of bona fide sales

If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.

Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(l)

Cross reference

(1)

For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2)

For right of each partner to make election under this section, see section 703(b).

(3)

For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a).

(4)

For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038

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[1] See References in Text note below.

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THOMSON FINDLAW

Eisner v. Macomber
No. 318
Argued April 16, 1919
Restored to docket for reargument May 19, 1919
Reargued October 17, 20, 1919
Decided March 8, 1920
252 U.S. 189

ERROR TO THE DISTRICT COURT OF THE UNITED STATES

FOR THE SOUTHERN DISTRICT OF NEW YORK

Syllabus

Congress was not empowered by the Sixteenth Amendment to tax, as income of the stockholder, without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913. P. 201. *Towne v. Eisner,* 245 U.S. 418.

The Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, plainly evinces the purpose of Congress to impose such taxes, and is to that extent in conflict with Art. I, § 2, cl. 3, and Art. I, § 9, cl. 4, of the Constitution. Pp. 199, 217.

These provisions of the Constitution necessarily limit the extension, by construction, of the Sixteenth Amendment. P. 205.

What is or is not "income" within the meaning of the Amendment must be determined in each case according to truth and substance, without regard to form. P. 206.

Income may be defined as the gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. P. 207.

Mere growth or increment of value in a capital investment is not income; income is essentially a gain or profit, in itself, of exchangeable value, proceeding from capital, severed from it, and derived or received by the taxpayer for his separate use, benefit, and disposal. *Id.*

A stock dividend, evincing merely a transfer of an accumulated surplus to the capital account of the corporation, takes nothing from the property of the corporation and adds nothing to that of the shareholder; a tax on such dividends is a tax an capital increase, and not on income, and, to be valid under the Constitution, such taxes must be apportioned according to population in the several states. P. 208.

Affirmed. [252 U.S. 190]

The case is stated in the opinion. [252 U.S. 199]

PITNEY, J., lead opinion

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.,* which, in our opinion (notwithstanding a contention of the government that will be [252 U.S. 200] noticed), plainly evinces the purpose of Congress to tax stock dividends as income.*

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 percent 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. 201] shares, of which 18.07 percent, 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 I, § 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, 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 reexamination 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, c. 16, 38 Stat. 114, 166, which provided (§ B, p. 167) that net income should include "dividends," and also "gains or profits and income derived [252 U.S. 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 F. 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, and quoted the Amendment, proceeded very properly to say (p. 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, "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 (p. 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):

> 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. 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. 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. 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. 204] based upon profits earned before the amendment. We ruled at the same term, in *Lynch v. Hornby,* 247 U.S. 339, that a cash dividend extraordinary in amount, and in *Peabody v. Eisner,* 247 U.S. 347, 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 (pp. 343-344):

> 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 preexisting 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, 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. 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) 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, under the Act of August 27, 1894, c. 349, § 27, 28 Stat. 509, 553, 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 I, § 2, cl. 3, and § 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. 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. Co.,* 240 U.S. 1, 17-19; *Stanton v. Baltic Mining Co.,* 240 U.S. 103, 112 *et seq.; Peck & Co. v. Lowe,* 247 U.S. 165, 172-173.

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 I 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. 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; *Doyle v. Mitchell Bros. Co.,* 247 U.S. 179, 185), "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, pp. 183-185.

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. 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. 209] from the company, he can do so only by disposing of his stock.

For bookkeeping 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. 210] 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 [252 U.S. 211] "surplus"; it does not alter the preexisting 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. [252 U.S. 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 percent 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. 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. 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 that the new certificates measure the extent 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. 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.

Two recent decisions, proceeding from courts of high jurisdiction, are cited in support of the position of the government. [252 U.S. 216]

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, 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" (pp. 526, 531), and that under it, a stock dividend was taxable as income, the court saying (p. 535):

> 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. 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. 218] 12 Wall. 1, which arose under § 117 of the Act of June 30, 1864, c. 173, 13 Stat. 223, 282, 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 (p. 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.

Insofar 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. 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. 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, insofar as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article I, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the Sixteenth Amendment.

Judgment affirmed.

HOLMES, J., dissenting

MR. JUSTICE HOLMES, dissenting.

I think that *Towne v. Eisner,* 245 U.S. 418, 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. I think that the word "incomes" in the Sixteenth Amendment should be read in [252 U.S. 220] "a sense most obvious to the common understanding at the time of its adoption." *Bishop v. State,* 149 Ind. 223, 230; *State v. Butler,* 70 Fla. 102, 133. 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.

MR. JUSTICE DAY concurs in this opinion.

BRANDEIS, J., dissenting

MR. JUSTICE BRANDEIS delivered the following opinion, in which MR. JUSTICE CLARKE concurred.

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. 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 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.

(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. 222] 1912, it increased its capital stock to $30,000,000, and paid a simple stock dividend of 2,900 percent in stock.{1}

(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 percent, increasing the outstanding capital to $800,000. During the calendar year 1912, it paid cash dividends aggregating 20 percent, 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 percent, thus increasing the capital to $1,000,000.{2}

(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 percent). 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 percent and 20 percent, 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. 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 percent 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 percent, 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 percent, payable May 1, 1917, being exchanged for one share of new stock, the equivalent of a 100 percent 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 percent was paid February 14, 1914, and one of 100 percent 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 percent January and April; 6 percent July and October), and adds in a note: "In addition, a stock dividend of 100 percent was paid during the year."{3} The Wall Street Journal of [252 U.S. 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; *Matter of Osborne,* 209 N.Y. 450, and also, where the question arose in matters of taxation, *People v. Glynn,* [252 U.S. 225] 130 App.Div. 332, 198 N.Y. 605. 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, 58 Cal.Dec. 97, 180 Cal. 748.

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. 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; *Legal Tender Case,* 110 U.S. 421, 444; *Lithograph Co. v. Sarony,* 111 U.S. 53, 58; *United States v. Realty Co.,* 163 U.S. 427, 440-442; *South Carolina v. United States,* 199 U.S. 437, 448-449. 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. 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. 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 anyone 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; *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. 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. 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. Businessmen, 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 Collector v. Hubbard,* 12 Wall. 1. The undivided share of a partner in the year's undistributed profits of his firm [252 U.S. 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. *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.{4} 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. 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.{5} 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. 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 § 3 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:

> 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. 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, which involved a question not of constitutional power, but of statutory construction, and *Gibbons v. Mahon,* 136 U.S. 549, 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 (p. 425): "But it is not necessarily true that income means the same thing in the Constitution and the [an] act."{6} *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. 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, 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 [252 U.S. 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 (p. 560), 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. The Supreme Judicial 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 Co., Ltd. v. Rex,* [1914] A.C. 231. In dismissing the appeal, these words of the Chief Justice of the Supreme Court of Western Australia were quoted (p. 236), which show that the facts involved were identical with those in the case at bar:

> Had the company distributed the £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 £101,450 [252 U.S. 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.{7} 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. 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.{8}

> 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

PITNEY, J., lead opinion (Footnotes)

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> 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.

BRANDEIS, J., dissenting (Footnotes)

1. Moody's p. 1544; Commercial and Financial Chronicle, Vol. 94, p. 831; Vol. 98, pp. 1005, 1076.

2. Moody's, p. 1548; Commercial and Financial Chronicle, Vol. 94, p. 771; Vol. 96, p. 1428; Vol. 97, p. 1434; Vol. 98, p. 1541.

3. 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 percent) -- $2,000,000," and describes the 1917 dividend as "$3,000,000 special cash dividend."

4. *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.

5. The hardship supposed to have resulted from such a decision has been removed in the Revenue Act of 1916 as amended, by providing in § 31b 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.

6. *Compare* Rugg, C.J., in *Tax Commissioner v. Putnam,* 227 Mass. 522, 533:

> 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.

7. *Compare* Rugg, C.J., *Tax Commissioner v. Putnam,* 227 Mass. 522, 524:

> 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.

8.

> 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.

U.S. Code collection

TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter J

Subchapter J—Estates, Trusts, Beneficiaries, and Decedents

How Current is This?

U.S. Code collection

TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter J > PART I

PART I—ESTATES, TRUSTS, AND BENEFICIARIES

U.S. Code collection

Subpart A—General Rules for Taxation of Estates and Trusts

How Current is This?

U.S. Code collection

§ 643. Definitions applicable to subparts A, B, C, and D

How Current is This?

(a) Distributable net income

For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) Deduction for distributions

No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) Deduction for personal exemption

No deduction shall be taken under section 642 (b) (relating to deduction for personal exemptions).

(3) Capital gains and losses

Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not

(A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or

(B) paid, permanently set aside, or to be used for the purposes specified in section 642 (c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

(4) Extraordinary dividends and taxable stock dividends

For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) Tax-exempt interest

There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) Income of foreign trust

In the case of a foreign trust—

(A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265 (a)(1) (relating to disallowance of certain deductions).

(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).

(C) Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

(7) Abusive transactions

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent avoidance of such purposes.

If the estate or trust is allowed a deduction under section 642 (c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642 (c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all -classes.

(b) Income

For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

(c) Beneficiary

For purposes of this part, the term "beneficiary" includes heir, legatee, devisee.

(d) Coordination with back-up withholding

Except to the extent otherwise provided in regulations, this subchapter shall be applied with respect to payments subject to withholding under section 3406—

(1) by allocating between the estate or trust and its beneficiaries any credit allowable under section 31 (c) (on the basis of their respective shares of any such payment taken into account under this subchapter),

(2) by treating each beneficiary to whom such credit is allocated as if an amount equal to such credit has been paid to him by the estate or trust, and

(3) by allowing the estate or trust a deduction in an amount equal to the credit so allocated to beneficiaries.

(e) Treatment of property distributed in kind

(1) Basis of beneficiary

The basis of any property received by a beneficiary in a distribution from an estate or trust shall be—

(A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for

(B) any gain or loss recognized to the estate or trust on the distribution.

(2) Amount of distribution

In the case of any distribution of property (other than cash), the amount taken into account under sections 661 (a)(2) and 662 (a)(2) shall be the lesser of—

(A) the basis of such property in the hands of the beneficiary (as determined under paragraph (1)), or

(B) the fair market value of such prop-erty.

(3) Election to recognize gain

(A) In general

In the case of any distribution of property (other than cash) to which an election under this paragraph applies—

(i) paragraph (2) shall not apply,

(ii) gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and

(iii) the amount taken into account under sections 661 (a)(2) and 662 (a)(2) shall be the fair market value of such property.

(B) Election

Any election under this paragraph shall apply to all distributions made by the estate or trust during a taxable year and shall be made on the return of such estate or trust for such taxable year.

Any such election, once made, may be revoked only with the consent of the Secretary.

(4) Exception for distributions described in section 663 (a)

This subsection shall not apply to any distribution described in section 663 (a).

(f) Treatment of multiple trusts

For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

(g) Certain payments of estimated tax treated as paid by beneficiary

(1) In general

In the case of a trust—

(A) the trustee may elect to treat any portion of a payment of estimated tax made by such trust for any taxable year of the trust as a payment made by a beneficiary of such trust,

(B) any amount so treated shall be treated as paid or credited to the beneficiary on the last day of such taxable year, and

(C) for purposes of subtitle F, the amount so treated—

(i) shall not be treated as a payment of estimated tax made by the trust, but

(ii) shall be treated as a payment of estimated tax made by such beneficiary on January 15 following the taxable year.

(2) Time for making election

An election under paragraph (1) shall be made on or before the 65th day after the close of the taxable year of the trust and in such manner as the Secretary may prescribe.

(3) Extension to last year of estate

In the case of a taxable year reasonably expected to be the last taxable year of an estate—

(A) any reference in this subsection to a trust shall be treated as including a reference to an estate, and

(B) the fiduciary of the estate shall be treated as the trustee.

(h) Distributions by certain foreign trusts through nominees

For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person.

(i) Loans from foreign trusts

For purposes of subparts B, C, and D—

(1) General rule

Except as provided in regulations, if a foreign trust makes a loan of cash or marketable securities directly or indirectly to—

(A) any grantor or beneficiary of such trust who is a United States person, or

(B) any United States person not described in subparagraph (A) who is related to such grantor or beneficiary,

the amount of such loan shall be treated as a distribution by such trust to such grantor or beneficiary (as the case may be).

(2) Definitions and special rules

For purposes of this subsection—

(A) Cash

The term "cash" includes foreign currencies and cash equivalents.

(B) Related person

(i) In general A person is related to another person if the relationship between such persons would result in a disallowance of losses under section 267 or 707 (b). In applying section 267 for purposes of the preceding sentence, section 267 (c)(4) shall be applied as if the family of an individual includes the spouses of the members of the family.

(ii) Allocation If any person described in paragraph (1)(B) is related to more than one person, the grantor or beneficiary to whom the treatment under this subsection applies shall be determined under regulations prescribed by the Secretary.

(C) Exclusion of tax-exempts

The term "United States person" does not include any entity exempt from tax under this chapter.

(D) Trust not treated as simple trust

Any trust which is treated under this subsection as making a distribution shall be treated as not described in section 651.

(3) Subsequent transactions regarding loan principal

If any loan is taken into account under paragraph (1), any subsequent transaction between the trust and the original borrower regarding the principal of the loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) shall be disregarded for purposes of this title.

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Doyle v. Mitchell Brothers Company
No. 492
Argued March 4, 5, 6, 1918
Decided May 20, 1918
247 U.S. 179

Editor's note: this case begins in mid-page. It therefore shares a citation with the last page of the previous case. If you are attempting to follow a link to the last page of 247 U.S. 175, click here.

CERTIORARI TO THE CIRCUIT COURT OF APPEALS

FOR THE SIXTH CIRCUIT

Syllabus

The purpose of the Corporation Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112, 38, is 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.

The act employs the term "income" in its natural and obvious sense, as importing something distinct from principal or capital, and conveying the idea of gain or increase arising from corporate activities.

While a conversion of capital may result in income, in the sense of the act, where the proceeds include an increment of value, such is not the case where the increment existed when the act took effect.

In distinguishing preexisting capital from income subject to the act, it is a mere question of method whether a deduction be made from gross receipts in ascertaining gross income, or from gross income, by way of depreciation, in ascertaining net income.

Before the Corporation Tax Act, a lumber company bought timber land [247 U.S. 180] to supply its mills, and after the act, it manufactured part of the timber into lumber, which it sold. *Held* that the amount by which the timber so used had increased in value between the date of purchase and the effective date of the act was not an element of income to be considered in computing the tax.

The principle upon which the removal of minerals by mining companies has been held not to produce a depreciation within the meaning of the act is inapplicable to the case of a company engaged in the business of manufacturing and selling lumber from timber supplied by it own timber lands, and which sell the lands incidentally after the timber is removed.

The income is to be determined from the actual fact, as to which the corporate books are only evidential.

235 F. 686 affirmed.

The case is stated in the opinion.

PITNEY, J., lead opinion

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, c. 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 F. 437; 235 F. 686), 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. 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 byproducts 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 allowed [247 U.S. 182] 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 byproducts, and a parcel of real estate, 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 percentum 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. 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, the tax was imposed

> not upon the franchises of the corporation irrespective of their use in business, nor upon the property 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. Co.,* 228 U.S. 295, 300; *United*

States v. Whitridge, 231 U.S. 144, 147; *Anderson v. Forty-Two Broadway,* 239 U.S. 69, 72.

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. 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, and *Anderson v. Forty-Two Broadway,* 239 U.S. 69, 72, 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. 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: "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. 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. 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. 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 income. 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; *United States v. Biwabik Mining Co., ante,* 116; *Goldfield Consolidated Mines Co. v. Scott, ante,* 126.

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. 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

PITNEY, J., lead opinion (Footnotes)

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.

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.

Stratton's Independence, Ltd. v. Howbert
No. 457
Argued October 211 1913
Decided December 1, 1913
231 U.S. 399

Editor's note: this case begins in mid -page. It therefore shares a citation with the last page of the previous case. If you are attempting to follow a link to the last page of 231 U.S. 394, click here.

CERTIFICATE FROM THE CIRCUIT COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

Syllabus

The Corporation Tax Law of August 5, 1909, c. 6, 36 Stat. 11, 112, applies to mining corporations.

Income, within the meaning of the Corporation Tax Law of 1909, includes the proceeds of ores mined by a corporation from its own premises.

A corporation mining ores from its own premises is not entitled to deduct from the proceeds of the ores mined, by way of depreciation under the Corporation Tax Law of 1909, the difference between the gross proceeds of the sales of ores during the year and the moneys expended in extracting, mining, and marketing the ores. [231 U.S. 400]

The Corporation Tax Law of 1909, having been enacted before the ratification of the Sixteenth Amendment, was not in any proper sense an income tax law; but was an excise tax upon the conduct of business in a corporate capacity measured by the income, with certain qualifications prescribed by the act itself.

The process of mining ores is, in a sense, equivalent in its results to a manufacturing process, and is "business" within the Corporation Tax Law of 1909.

Income may be defined as the gain derived from capital, from labor, or from both combined.

In fixing the income by which the excise on conducting business should be measured, Congress has power to fix the gross income even though such income involved a wasting of the capital as in mining ores.

The Corporation Tax Law deals with corporations engaged in actual business transactions and presumably conducted according to business principles.

Whatever may be the proper method of computing depreciation under the Corporation Tax Taw by reason of taking ore from the premises of a mining corporation, the rules applicable to liability of trespassers for taking ore have only a modified application thereto.

Where the case is here under § 239, Judicial Code, and the whole record has not been sent up, this Court, under Rule 37, deals with the facts as certified, and not otherwise; under such circumstances, it answers only the questions of law certified, and does not go into questions of fact or of mixed law and fact.

The facts, which involve the construction of the Corporation Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112, and its application to mining corporations are stated in the opinion. [231 U.S. 406]

PITNEY, J., lead opinion

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. 11, 112, c. 6. 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. 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., p. 11)?
>
> 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. p. 11), 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. 408]

The provisions of § 38 are set forth in the margin.*

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. 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 [231 U.S. 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 [231 U.S. 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 [231 U.S. 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 [231 U.S. 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 & 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 [231 U.S. 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; *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 [231 U.S. 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. 416] 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 [231 U.S. 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 percentum 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 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. 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 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 [231 U.S. 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. 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. 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 Woodenware 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, [231 U.S. 422] 352; *Jegon v. Vivian* (1871), L.R. 6 Ch. 742, 760, 40 L.J.Ch. N.S. 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 300, 54 Am.Rep. 415; *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 (derived from § 6 of the Evarts Act, March 3, 1891, 26 Stat. 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 [231 U.S. 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

*

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 percentum 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 in 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 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 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 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.

Stanton v. Baltic Mining Company
No. 359
Argued October 14, 15, 1915
Decided February 21, 1916
240 U.S. 103

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES

FOR THE DISTRICT OF MASSACHUSETTS

Syllabus

Brushaber v. Un. P. R. Co., ante, p. 1, followed to effect that the district court has jurisdiction of an action by a stockholder against the corporation to enjoin it from voluntarily paying the tax under the Income Tax Law of 1913 on the ground of its unconstitutionality.

This Court has, under § 238, Jud.Code, jurisdiction of a direct appeal from the judgment of the district court refusing to enjoin a corporation from paying the tax under the Income Tax Law of 1913, in a suit brought by a stockholder on the ground of unconstitutionality of the statute.

The Income Tax Law of 1913 is not unconstitutional as not conforming with, or being beyond the authority of, the Sixteenth Amendment. *Brushaber v. Un. P. R. Co., ante,* p. 1.

There is no authority for taking taxation of mining corporations out of the rule established by the Sixteenth Amendment; nor is there any basis for the contention that, owing to inadequacy of the allowance for depreciation of ore body, the income tax of 1913 is equivalent to one on the gross product of mines, and, as such, a direct tax on the property itself, and therefore beyond the purview of that amendment and void for want of apportionment.

Independently of the operations of the Sixteenth Amendment, a tax on the product of the mine is not a tax upon property as such because of its ownership, but is a true excise levied on the result of the business of carrying on mining operations. *Stratton's Independence v. Howbert,* 231 U.S. 399.

The facts, which involve the constitutionality and construction of provisions of the Income Tax Law of 1913 and its application to mining corporations, are stated in the opinion. [240 U.S. 107]

WHITE, J., lead opinion

MR. CHIEF JUSTICE WHITE delivered the opinion of the Court.

As in *Brushaber v. Union P. R. Co., ante,* p. 1, this case was commenced by the appellant as a stockholder of the Baltic Mining Company, the appellee, to enjoin the voluntary payment by the corporation and its officers of the tax assessed against it under the income tax section of the Tariff Act of October 3, 1913, c. 16, 38 Stat. 166. As to the grounds for the equitable relief [240 U.S. 108] sought in this case so far as the question of jurisdiction is concerned are substantially the same as those which were relied upon in the *Brushaber* case, it follows that the ruling in that case upholding the power to dispose of that controversy is controlling here, and we put that subject out of view.

Further, also like the *Brushaber* case, this is before us on a direct appeal prosecuted for the purpose of reviewing the action of the court below in dismissing on motion the bill for want of equity.

The bill averred:

> That, under and by virtue of the alleged authority contained in said income tax law, if valid and constitutional, the respondent company is taxable at the rate of one percent upon its gross receipts from all sources, during the calendar year ending December 31, 1914, after deducting (1) its ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, and (2) all losses actually sustained within the year, and not compensated by insurance or otherwise, including depreciation arising from depletion of its ore deposits to the limited extent of five percent of the "gross value at the mine of the output" during said year.

It was further alleged that the company would, if not restrained, make a return for taxation conformably to the statute, and would pay the tax upon the basis stated without protest, and that to do so would result in depriving the complainant as a stockholder of rights secured by the Constitution of the United States, as the tax which it was proposed to pay without protest was void for repugnancy to that Constitution. The bill contained many averments on the following subjects, which may be divided into two generic classes: (A) those concerning the operation of the law in question upon individuals generally and upon other than mining corporations, and the discrimination against mining corporations which arose in favor of such other corporations and individuals [240 U.S. 109] by the legislation, as well as discrimination which the provisions of the act operated against mining corporations because of the separate and more unfavorable burden cast upon them by the statute than was placed upon other corporations and individuals -- averments all of which were obviously made to support the subsequent charges which the bill contained as to the repugnancy of the law imposing the tax to the equal protection, due process, and uniformity clauses of the Constitution, and (B) those dealing with the practical results on the company of the operation of the tax in question, evidently alleged for the purpose of sustaining the charge which the bill made that the tax levied was not what was deemed to be the peculiar direct tax which the Sixteenth Amendment exceptionally authorized to be levied without apportionment, and of the resulting repugnancy of the tax to the Constitution as a direct tax on property because of its ownership, levied without conforming to the regulation of apportionment generally required by the Constitution as to such taxation.

We need not more particularly state the averments as to the various contentions in class (A), as their character will necessarily be made manifest by the statement of the legal propositions based on them which we shall hereafter have occasion to make. As to the averments concerning class (B), it suffices to say that it resulted from copious allegations in the bill as to the value of the ore body contained in the mine which the company worked, and the total output for the year of the product of the mine after deducting the expenses as previously stated; that the five percent deduction permitted by the statute was inadequate to allow for the depletion of the ore body, and therefore the law to a large extent taxed not the mere profit arising from the operation of the mine, but taxed as income the yearly product which represented to a large extent the yearly depletion or exhaustion of [240 U.S. 110] the ore body from which, during the year, ore was taken. Indeed, the following alleged facts concerning the relation which the annual production bore to the exhaustion or diminution of the property in the ore bed must be taken as true for the purpose of reviewing the judgment sustaining the motion to dismiss the bill.

> That the real or actual yearly income derived by the respondent company from its business or property does not exceed $550,000. That, under the income tax, the said company is held taxable, in an average year, to the amount of approximately $1,150,000, the same being ascertained by deducting from its net receipts of $1,400,000 only a depreciation of $100,000 on its plant and a depletion of its ore supply limited by law to five percent of the value of its annual gross receipts, and amounting to $150,000; whereas, in order properly to ascertain its actual income, $750,000 per annum should be allowed to be deducted for such depletion, or five times the amount actually allowed.

Without attempting minutely to state every possible ground of attack which might be deduced from the averments of the bill, but in substance embracing every material grievance therein asserted and pressed in argument upon our attention in the elaborate briefs which have been submitted, we come to separately dispose of the legal propositions advanced in the bill and arguments concerning the two classes.

Class A. Under this, the bill charged that the provisions of the statute

> are unconstitutional and void under the Fifth Amendment in that they deny to mining companies and their stockholders equal protection of the laws and deprive them of their property without due process of law

for the following reasons:

(1) Because all other individuals or corporations were given a right to deduct a fair and reasonable percentage for losses and depreciation of their capital, and they were [240 U.S. 111] therefore not confined to the arbitrary five percent

fixed as the basis for deductions by mining corporations.

(2) Because, by reason of the differences in the allowances which the statute permitted, the tax levied was virtually a net income tax on other corporations and individuals, and a gross income tax on mining corporations.

(3) Because the statute established a discriminating rule as to individuals and other corporations as against mining corporations on the subject of the method of the allowance for depreciations.

(4) Because the law permitted all individuals to deduct from their net income dividends received from corporations which had paid the tax on their incomes, and did not give the right to corporations to make such deductions from their income of dividends received from other corporations which had paid their income tax. This was illustrated by the averment that 99 percent of the stock of the defendant company was owned by a holding company, and that, under the statute, not only was the corporation obliged to pay the tax on its income, but so also was the holding company obliged to pay on the dividends paid it by the defendant company.

(5) Because of the discrimination resulting from the provision of the statute providing for a progressive increase of taxation or surtax as to individuals, and not as to corporations.

(6) Because of the exemptions which the statute made of individual incomes below $4,000, and of incomes of labor organizations and various other exemptions which were set forth.

But it is apparent from the mere statement of these contentions that each and all of them were adversely disposed of by the decision in the *Brushaber* case, and they all therefore may be put out of view.

Class B. Under this class, these propositions are relied upon: [240 U.S. 112]

(1) That, as the Sixteenth Amendment authorizes only an exceptional direct income tax without apportionment, to which the tax in question does not conform, it is therefore not within the authority of that Amendment.

(2) Not being within the authority of the Sixteenth Amendment, the tax is therefore, within the ruling of *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, a direct tax and void for want of compliance with the regulation of apportionment.

As the first proposition is plainly in conflict with the meaning of the Sixteenth Amendment as interpreted in the *Brushaber* case, it may also be put out of view. As to the second, while indeed it is distinct from the subjects considered in the *Brushaber* case to the extent that the particular tax which the statute levies on mining corporations here under consideration is distinct from the tax on corporations other than mining and on individuals, which was disposed of in the *Brushaber* case, a brief analysis will serve to demonstrate that the distinction is one without a difference, and therefore that the proposition is also foreclosed by the previous ruling. The contention is that as the tax here imposed is not on the net product, but in a sense somewhat equivalent to a tax on the gross product of the working of the mine by the corporation; therefore the tax is not within the purview of the Sixteenth Amendment, and consequently it must be treated as a direct tax on property because of its ownership, and as such void for want of apportionment. But, aside from the obvious error of the proposition, intrinsically considered, it manifestly disregards the fact that, by the previous ruling, it was settled that the provisions of the Sixteenth Amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged, and being placed [240 U.S. 113] in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived -- that is, by testing the tax not by what it was, a tax on income, but by a mistaken theory deduced from the origin or source of the income taxed. Mark, of course, in saying this we are not here considering a tax not within the provisions of the Sixteenth Amendment -- that is, one in which the regulation of apportionment or the rule of uniformity is wholly negligible because the tax is one entirely beyond the scope of the taxing power of Congress, and where consequently no authority to impose a burden, either direct or indirect, exists. In other words, we are here dealing solely with the restriction imposed by the Sixteenth Amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect, to which it generically belongs, and putting it in the class of direct, to which it would not otherwise belong, in order to subject it to the regulation of apportionment. But it is said that, although this be undoubtedly true as a general rule, the peculiarity of mining property and the exhaustion of the ore body which must result from working the mine cause the tax in a case like this, where an inadequate allowance by way of deduction is made for the exhaustion of the ore body, to be in the nature of things a tax on property because of its ownership, and therefore subject to apportionment. Not to so hold, it is urged, is as to mining property but to say that mere form controls, thus rendering in substance the command of the Constitution that taxation directly on property because of its ownership be apportioned wholly illusory or futile. But this merely asserts a right to take the taxation of mining corporations out of the rule established by the Sixteenth Amendment when there is no authority for so doing. It moreover rests upon the wholly fallacious [240 U.S. 114] assumption that, looked at from the point of view of substance, a tax on the product of a mine is necessarily, in its essence and nature in every case, a direct tax on property because of its ownership unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious assumption because, independently of the effect of the operation of the Sixteenth Amendment, it was settled in *Stratton's Independence v. Howbert,* 231 U.S. 399, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations. Pp. 413 *et seq.*

As it follows from what we have said that the contentions are in substance and effect controlled by the *Brushaber* case, and, insofar as this may not be the case, are without merit, it results that, for the reasons stated in the opinion in that case and those expressed in this, the judgment must be, and it is,

Affirmed.

MR. JUSTICE McREYNOLDS took no part in the consideration and decision of this case.

Brushaber v. Union Pacific Railroad Company
No. 140
Argued October 14, 15, 1915
Decided January 24, 1916
240 U.S. 1

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES

FOR THE SOUTHERN DISTRICT OF NEW YORK

Syllabus

Under proper averments, a stockholder's suit to restrain a corporation from voluntarily paying a tax charged to be unconstitutional is not violative of Rev.Stat. § 3224, and the district court has jurisdiction to entertain the action. *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429.

In this case -- that of a stockholder against a corporation to restrain the latter from voluntarily paying the income tax imposed by the Tariff Act of 1913 -- the defendant corporation notified the government of the pendency of the action and the United States was heard as *amicus curiae* in support of the constitutionality of the Act.

The Sixteenth Amendment was obviously intended to simplify the situation and make clear the limitations on the taxing power of Congress and not to create radical and destructive changes in our constitutional system.

The Sixteenth Amendment does not purport to confer power to levy income taxes in a generic sense, as that authority was already possessed, [240 U.S. 2] or to limit and distinguish between one kind of income tax and another, but its purpose is to relieve all income taxes when imposed from apportionment from consideration of the source whence the income is derived.

The Income Tax provisions of the Tariff Act of 1913 are not unconstitutional by reason of retroactive operation, the period covered not extending prior to the time when the Amendment was operative, nor are those provisions unconstitutional under the due process provision of the Fifth Amendment, nor do they deny due process of law, nor equal protection of the law by reason of the classifications therein of things or persons subject to the tax.

The provisions for collecting income at the source do not deny due process of law by reason of duties imposed upon corporations without compensation in connection with the payment of the tax by others.

The uniformity of taxation required by the federal Constitution is geographical. *Knowlton v. Moore,* 178 U.S. 41.

The Fifth Amendment is not a limitation upon the taxing power conferred upon Congress by the Constitution.

Arguments as to the expediency of levying a tax which is within the power of Congress to levy are beyond judicial cognizance.

When there are differences between the subjects that are taxed, Congress does not transcend the limit of its taxing power by taxing them differently.

A want of due process of law does not arise from want of wisdom in Congress in levying taxes, and thus give the courts power to overrule the action of Congress by declaring it to be unconstitutional.

The facts, which involve the construction of the Sixteenth Amendment and other provisions of the Constitution of the United States, and the constitutionality of the income tax provisions of the Tariff Act of October 9, 1913, are stated in the opinion. [240 U.S. 9]

WHITE, J., lead opinion

MR. CHIEF JUSTICE WHITE delivered the opinion of the Court.

As a stockholder of the Union Pacific Railroad Company, the appellant filed his bill to enjoin the corporation from complying with the income tax provisions of the tariff act of October 3, 1913 (§ II., c. 16, 38 Stat. 166). Because of constitutional questions duly arising, the case is here on direct appeal from a decree sustaining a motion to dismiss because no ground for relief was stated.

The right to prevent the corporation from returning and paying the tax was based upon many averments as to the repugnancy of the statute to the Constitution of the United States, of the peculiar relation of the corporation to the stockholders, and their particular interests resulting from many of the administrative provisions of the assailed act, of the confusion, wrong, and multiplicity [240 U.S. 10] of suits and the absence of all means of redress which would result if the corporation paid the tax and complied with the act in other respects without protest, as it was alleged it was its intention to do. To put out of the way a question of jurisdiction, we at once say that, in view of these averments and the ruling in *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, sustaining the right of a stockholder to sue to restrain a corporation under proper averments from voluntarily paying a tax charged to be unconstitutional on the ground that to permit such a suit did not violate the prohibitions of § 3224 Rev.Stat. against enjoining the enforcement of taxes, we are of opinion that the contention here made that there was no jurisdiction of the cause, since to entertain it would violate the provisions of the Revised Statutes referred to, is without merit. Before coming to dispose of the case on the merits, however, we observe that the defendant corporation having called the attention of the government to the pendency of the cause and the nature of the controversy and its unwillingness to voluntarily refuse to comply with the act assailed, the United States, as *amicus curiae,* has at bar been heard both orally and by brief for the purpose of sustaining the decree.

Aside from averments as to citizenship and residence, recitals as to the provisions of the statute, and statements as to the business of the corporation, contained in the first ten paragraphs of the bill, advanced to sustain jurisdiction, the bill alleged twenty-one constitutional objections specified in that number of paragraphs or subdivisions. As all the grounds assert a violation of the Constitution, it follows that, in a wide sense, they all charge a repugnancy of the statute to the Sixteenth Amendment, under the more immediate sanction of which the statute was adopted.

The various propositions are so intermingled as to cause it to be difficult to classify them. We are of opinion, however, [240 U.S. 11] that the confusion is not inherent, but rather arises from the conclusion that the Sixteenth Amendment provides for a hitherto unknown power of taxation -- that is, a power to levy an income tax which, although direct, should not be subject to the regulation of apportionment applicable to all other direct taxes. And the far-reaching effect of this erroneous assumption will be made clear by generalizing the many contentions advanced in argument to support it, as follows: (a) The Amendment authorizes only a particular character of direct tax without apportionment, and therefore if a tax is levied under its assumed authority which does not partake of the characteristics exacted by the Amendment, it is outside of the Amendment, and is void as a direct tax in the general constitutional sense because not apportioned. (b) As the Amendment authorizes a tax only upon incomes "from whatever source derived," the exclusion from taxation of some income of designated persons and classes is not authorized, and hence the constitutionality of the law must be tested by the general provisions of the Constitution as to taxation, and thus again the tax is void for want of apportionment. (c) As the right to tax "incomes from whatever source derived" for which the Amendment provides must be considered as exacting intrinsic uniformity, therefore no tax comes under the authority of the Amendment not conforming to such standard, and hence all the provisions of the assailed statute must once more be tested solely under the general and preexisting provisions of the Constitution, causing the statute again to be void in the absence of apportionment. (d) As the power conferred by the Amendment is new and prospective, the attempt in the statute to make its provisions retroactively apply is void because, so far as the retroactive period is concerned, it is governed by the preexisting constitutional requirement as to apportionment.

But it clearly results that the proposition and the contentions [240 U.S. 12] under it, if acceded to, would cause one provision of the Constitution to destroy another; that is, they would result in bringing the provisions of the Amendment exempting a direct tax from apportionment into irreconcilable conflict with the general requirement that all direct taxes be apportioned. Moreover, the tax authorized by the Amendment, being direct, would not come under the rule of uniformity applicable under the Constitution to other than direct taxes, and thus it would come to pass that the result of the Amendment would be to authorize a particular direct tax not subject either to apportionment or to the rule of geographical uniformity, thus giving power to impose a different tax in one state or states than was levied in another state or states. This result, instead of simplifying the situation and making clear the limitations on the taxing power, which obviously the Amendment must have been intended to accomplish, would create radical and destructive changes in our constitutional system and multiply confusion.

But let us by a demonstration of the error of the fundamental proposition as to the significance of the Amendment dispel the confusion necessarily arising from the arguments deduced from it. Before coming, however, to the text of the Amendment, to the end that its significance may be determined in the light of the previous legislative and judicial history of the subject with which the Amendment is concerned, and with a knowledge of the conditions which presumptively led up to its adoption, and hence of the purpose it was intended to accomplish, we make a brief statement on those subjects.

That the authority conferred upon Congress by § 8 of Article I "to lay and collect taxes, duties, imposts and excises" is exhaustive and embraces every conceivable power of taxation has never been questioned, or, if it has, has been so often authoritatively declared as to render it necessary only to state the doctrine. And it has also never [240 U.S. 13] been questioned from the foundation, without stopping presently to determine under which of the separate headings the power was properly to be classed, that there was authority given, as the part was included in the whole, to lay and collect income taxes. Again, it has never moreover been questioned that the conceded complete and all-embracing taxing power was subject, so far as they were respectively applicable, to limitations resulting from the requirements of Art. I, § 8, cl. 1, that "all duties, imposts and excises shall be uniform throughout the United States," and to the limitations of Art I., § 2, cl. 3, that "direct taxes shall be apportioned among the several states," and of Art. I, § 9, cl. 4, that "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." In fact, the two great subdivisions embracing the complete and perfect delegation of the power to tax and the two correlated limitations as to such power were thus aptly stated by Mr. Chief Justice Fuller in *Pollock v. Farmers' Loan & Trust Co., supra,* at 557:

> In the matter of taxation, the Constitution recognizes the two great classes of direct and indirect taxes, and lays down two rules by which their imposition must be governed, namely, the rule of apportionment as to direct taxes, and the rule of uniformity as to duties, imposts, and excises.

It is to be observed, however, as long ago pointed out in *Veazie Bank v. Fenno,* 8 Wall. 533, 541, that the requirements of apportionment as to one of the great classes and of uniformity as to the other class were not so much a limitation upon the complete and all-embracing authority to tax, but in their essence were simply regulations concerning the mode in which the plenary power was to be exerted. In the whole history of the government down to the time of the adoption of the Sixteenth Amendment, leaving aside some conjectures expressed of the possibility of a tax lying intermediate between the two great classes and embraced [240 U.S. 14] by neither, no question has been anywhere made as to the correctness of these propositions. At the very beginning, however, there arose differences of opinion concerning the criteria to be applied in determining in which of the two great subdivisions a tax would fall. Without pausing to state at length the basis of these differences and the consequences which arose from them, as the whole subject was elaborately reviewed in *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, we make a condensed statement which is in substance taken from what was said in that case. Early the differences were manifested in pressing, on the one hand, and opposing, on the other, the passage of an act levying a tax without apportionment on carriages "for the conveyance of persons," and when such a tax was enacted, the question of its repugnancy to the Constitution soon came to this Court for determination. *Hylton v. United States,* 3 Dall. 171. It was held that the tax came within the class of excises, duties, and imposts, and therefore did not require apportionment, and while this conclusion was agreed to by all the members of the Court who took part in the decision of the case, there was not an exact coincidence in the reasoning by which the conclusion was sustained. Without stating the minor differences, it may be said with substantial accuracy that the divergent reasoning was this: on the one hand, that the tax was not in the class of direct taxes requiring apportionment, because it was not levied directly on property because of its ownership, but rather on its use, and was therefore an excise, duty, or impost, and on the other, that, in any event, the class of direct taxes included only taxes directly levied on real estate because of its ownership. Putting out of view the difference of reasoning which led to the concurrent conclusion in the *Hylton* case, it is undoubted that it came to pass in legislative practice that the line of demarcation between the two great classes of direct taxes, on the one hand, and excises, duties, and [240 U.S. 15] imposts, on the other, which was exemplified by the ruling in that case was accepted and acted upon. In the first place this is shown by the fact that, wherever (and there were a number of cases of that kind) a tax was levied directly on real estate or slaves because of ownership, it was treated as coming within the direct class and apportionment was provided for, while no instance of apportionment as to any other kind of tax is afforded. Again, the situation is aptly illustrated by the various acts taxing incomes derived from property of every kind and nature which were enacted beginning in 1861, and lasting during what may be termed the Civil War period. It is not disputable that these latter taxing laws were classed under the head of excises, duties, and imposts because it was assumed that they were of that character inasmuch as, although putting a tax burden on income of every kind, including that derived from property real or personal, they were not taxes directly on property because of its ownership. And this practical construction came in theory to be the accepted one, since it was adopted without dissent by the most eminent of the text writers. 1 Kent, Com. 254, 256; 1 Story, Const. § 955; Cooley, Const.Lim. 5th ed. *480; Miller on the Constitution 237; Pomeroy's Constitutional Law § 281; Hare, Const.Law, Vol. 1, 249, 250; Burroughs on Taxation 502; Ordronaux, Constitutional Legislation 225.

Upon the lapsing of a considerable period after the repeal of the income tax laws referred to, in 1894, an act was passed laying a tax on incomes from all classes of property and other sources of revenue which was not apportioned, and which therefore was, of course, assumed to come within the classification of excises, duties, and imposts which were subject to the rule of uniformity, but not to the rule of apportionment. The constitutional validity of this law was challenged on the ground that it did not fall within the class of excises, duties, and imposts, [240 U.S. 16] but was direct in the constitutional sense, and was therefore void for want of apportionment, and that question came to this Court and was passed upon in *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429; 158 U.S. 601. The Court, fully recognizing in the passage which we have previously quoted the all-embracing character of the two great classifications, including, on the one hand, direct taxes subject to apportionment, and on the other, excises, duties, and imposts subject to uniformity, held the law to be unconstitutional in substance for these reasons: concluding that the classification of direct was adopted for the purpose of rendering it impossible to burden by taxation accumulations of property, real or personal, except subject to the regulation of apportionment, it was held that the duty existed to fix what was a direct tax in the constitutional sense so as to accomplish this purpose contemplated by the Constitution. (157 U.S. 581.) Coming to consider the validity of the tax from this point of view, while not questioning at all that in common understanding it was direct merely on income and only indirect on property, it was held that, considering the substance of things, it was direct on property in a constitutional sense, since to burden an income by a tax was, from the point of substance, to burden the property from which the income was derived, and thus accomplish the very thing which the provision as to apportionment of direct taxes was adopted to prevent. As this conclusion but enforced a regulation as to the mode of exercising power under particular circumstances, it did not in any way dispute the all-embracing taxing authority possessed by Congress, including necessarily therein the power to impose income taxes if only they conformed to the constitutional regulations which were applicable to them. Moreover, in addition, the conclusion reached in the *Pollock* case did not in any degree involve holding that income taxes generically and necessarily came within the class [240 U.S. 17] of direct taxes on property, but, on the contrary, recognized the fact that taxation on income was in its nature an excise entitled to be enforced as such unless and until it was concluded that to enforce it would amount to accomplishing the result which the requirement as to apportionment of direct taxation was adopted to prevent, in which case the duty would arise to disregard form and consider substance alone, and hence subject the tax to the regulation as to apportionment which otherwise as an excise would not apply to it. Nothing could serve to make this clearer than to recall that, in the *Pollock* case, insofar as the law taxed incomes from other classes of property than real estate and invested personal property -- that is, income from "professions, trades, employments, or vocations" (158 U.S. 637) -- its validity was recognized; indeed, it was expressly declared that no dispute was made upon that subject, and attention was called to the fact that taxes on such income had been sustained as excise taxes in the past. *Id.,* p. 635. The whole law was, however, declared unconstitutional on the ground that to permit it to thus operate would relieve real estate and invested personal property from taxation, and

> would leave the burden of the tax to be borne by professions, trades, employments, or vacations, and in that way what was intended as a tax on capital would remain, in substance, a tax on occupations and labor

(*id.,* p. 637) -- a result which, it was held, could not have been contemplated by Congress.

This is the text of the Amendment:

> 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.

It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense -- an authority already possessed and never questioned -- [240 U.S. 18] or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock* case, and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock* case was decided -- that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since, in express terms, the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment. From this in substance it indisputably arises, first, that all the contentions which we have previously noticed concerning the assumed limitations to be implied from the language of the Amendment as to the nature and character of the income taxes which it authorizes find no support in the text, and are in irreconcilable conflict with the very purpose which the Amendment was adopted to accomplish. Second, that the contention that the Amendment treats a tax on income as a direct tax although it is relieved from apportionment and is necessarily therefore not subject to the rule of uniformity as such rule only applies to taxes which are not direct, thus destroying the two great classifications which have been recognized and enforced from the beginning, is also wholly without foundation since the command of the Amendment that all income taxes shall not be subject to apportionment by a consideration of the sources from which the taxed income may be derived [240 U.S. 19] forbids the application to such taxes of the rule applied in the *Pollock* case by which alone such taxes were removed from the great class of excises, duties, and imposts subject to the rule of uniformity, and were placed under the other or direct class. This must be unless it can be said that, although the Constitution, as a result of the Amendment, in express terms excludes the criterion of source of income, that criterion yet remains for the purpose of destroying the classifications of the Constitution by taking an excise out of the class to which it belongs and transferring it to a class in which it cannot be placed consistently with the requirements of the Constitution. Indeed, from another point of view, the Amendment demonstrates that no such purpose was intended, and, on the contrary, shows that it was drawn with the object of maintaining the limitations of the Constitution and harmonizing their operation. We say this because it is to be observed that, although from the date of the *Hylton* case, because of statements made in the opinions in that case, it had come to be accepted that direct taxes in the constitutional sense were confined to taxes levied directly on real estate because of its ownership, the Amendment contains nothing repudiation or challenging the ruling in the *Pollock* case that the word "direct" had a broader significance, since it embraced also taxes levied directly on personal property because of its ownership, and therefore the Amendment at least impliedly makes such wider significance a part of the Constitution -- a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended -- that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself, and thereby to take an income tax out of the class of excises, duties, and imposts, and place it in the class of direct taxes. [240 U.S. 20]

We come, then, to ascertain the merits of the many contentions made in the light of the Constitution as it now stands -- that is to say, including within its terms the provisions of the Sixteenth Amendment as correctly interpreted. We first dispose of two propositions assailing the validity of the statute on the one hand because of its repugnancy to the Constitution in other respects, and especially because its enactment was not authorized by the Sixteenth Amendment.

The statute was enacted October 3, 1913, and provided for a general yearly income tax from December to December of each year. Exceptionally, however, it fixed a first period embracing only the time from March 1, to December 31, 1913, and this limited retroactivity is assailed as repugnant to the due process clause of the Fifth Amendment, and as inconsistent with the Sixteenth Amendment itself. But the date of the retroactivity did not extend beyond the time when the Amendment was operative, and there can be no dispute that there was power by virtue of the

Amendment during that period to levy the tax, without apportionment, and so far as the limitations of the Constitution in other respects are concerned, the contention is not open, since, in *Stockdale v. Atlantic Ins. Co.,* 20 Wall. 323, 331, in sustaining a provision in a prior income tax law which was assailed because of its retroactive character, it was said:

> The right of Congress to have imposed this tax by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted; much less can it be doubted that it could impose such a tax on the income of the current year, though part of that year had elapsed when the statute was passed. The joint resolution of July 4th, 1864, imposed a tax of five percent upon all income of the previous year, although one tax on it had already been paid, and no one doubted the validity of the tax or attempted to resist it. [240 U.S. 21]

The statute provides that the tax should not apply to enumerated organizations or corporations, such as labor, agricultural or horticultural organizations, mutual savings banks, etc., and the argument is that as the Amendment authorized a tax on incomes "from whatever source derived," by implication it excluded the power to make these exemptions. But this is only a form of expressing the erroneous contention as to the meaning of the Amendment, which we have already disposed of. And, so far as this alleged illegality is based on other provisions of the Constitution, the contention is also not open, since it was expressly considered and disposed of in *Flint v. Stone Tracy Co.,* 220 U.S. 107, 173.

Without expressly stating all the other contentions, we summarize them to a degree adequate to enable us to typify and dispose of all of them.

1. The statute levies one tax called a normal tax on all incomes of individuals up to $20,000, and from that amount up, by gradations, a progressively increasing tax, called an additional tax, is imposed. No tax, however, is levied upon incomes of unmarried individuals amounting to $3,000 or less, nor upon incomes of married persons amounting to $4,000 or less. The progressive tax and the exempted amounts, it is said, are based on wealth alone, and the tax is therefore repugnant to the due process clause of the Fifth Amendment.

2. The act provides for collecting the tax at the source -- that is, makes it the duty of corporations, etc., to retain and pay the sum of the tax on interest due on bonds and mortgages, unless the owner to whom the interest is payable gives a notice that he claims an exemption. This duty cast upon corporations, because of the cost to which they are subjected, is asserted to be repugnant to due process of law as a taking of their property without compensation, and we recapitulate various contentions as to discrimination against corporations and against individuals [240 U.S. 22] predicated on provisions of the act dealing with the subject.

(a) Corporations indebted upon coupon and registered bonds are discriminated against, since corporations not so indebted are relieved of any labor or expense involved in deducting and paying the taxes of individuals on the income derived from bonds.

(b) Of the class of corporations indebted as above stated, the law further discriminates against those which have assumed the payment of taxes on their bonds, since, although some or all of their bondholders may be exempt from taxation, the corporations have no means of ascertaining such fact, and it would therefore result that taxes would often be paid by such corporations when no taxes were owing by the individuals to the government.

(c) The law discriminates against owners of corporate bonds in favor of individuals none of whose income is derived from such property, since bondholders are, during the interval between the deducting and the paying of the tax on their bonds, deprived of the use of the money so withheld.

(d) Again, corporate bondholders are discriminated against because the law does not release them from payment of taxes on their bonds even after the taxes have been deducted by the corporation, and therefore if, after deduction, the corporation should fail, the bondholders would be compelled to pay the tax a second time.

(e) Owners of bonds the taxes on which have been assumed by the corporation are discriminated against because the payment of the taxes by the corporation does not relieve the bondholders of their duty to include the income from such bonds in making a return of all income, the result being a double payment of the taxes, labor and expense in applying for a refund, and a deprivation of the use of the sum of the taxes during the interval which elapses before they are refunded. [240 U.S. 23]

3. The provision limiting the amount of interest paid which may be deducted from gross income of corporations for the purpose of fixing the taxable income to interest on indebtedness not exceeding one half the sum of bonded indebtedness and paid-up capital stock is also charged to be wanting in due process because discriminating between different classes of corporations and individuals.

4. It is urged that want of due process results from the provision allowing individuals to deduct from their gross income dividends paid them by corporations whose incomes are taxed, and not giving such right of deduction to corporations.

5. Want of due process is also asserted to result from the fact that the act allows a deduction of $3,000 or $4,000 to those who pay the normal tax -- that is, whose incomes are $20,000 or less -- and does not allow the deduction to those whose incomes are greater than $20,000 -- that is, such persons are not allowed, for the purpose of the additional or progressive tax, a second right to deduct the $3,000 or $4,000 which they have already enjoyed. And a further violation of due process is based on the fact that, for the purpose of the additional tax no second right to deduct dividends received from corporations is permitted.

6. In various forms of statement, want of due process, it is moreover insisted, arises from the provisions of the act allowing a deduction for the purpose of ascertaining the taxable income of stated amounts, on the ground that the provisions discriminate between married and single people, and discriminate between husbands and wives who are living together and those who are not.

7. Discrimination and want of due process result, it is said, from the fact that the owners of houses in which they live are not compelled to estimate the rental value in making up their incomes, while those who are living in rented houses and pay rent are not allowed, in making up their taxable income, to deduct rent which they have [240 U.S. 24] paid, and that want of due process also results from the fact that, although family expenses are not, as a rule, permitted to be deducted from gross, to arrive at taxable, income, farmers are permitted to omit from their income return certain products of the farm which are susceptible of use by them for sustaining their families during the year.

So far as these numerous and minute, not to say in many respects hypercritical, contentions are based upon an assumed violation of the uniformity clause, their want of legal merit is at once apparent, since it is settled that that clause exacts only a geographical uniformity, and there is not a semblance of ground in any of the propositions for assuming that a violation of such uniformity is complained of. *Knowlton v. Moore,* 178 U.S. 41; *Patton v. Brady,* 184 U.S. 608, 622; *Flint v. Stone Tracy Co.,* 220 U.S. 107, 158; *Billings v. United States,* 232 U.S. 261, 282.

So far as the due process clause of the Fifth Amendment is relied upon, it suffices to say that there is no basis for such reliance, since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict with itself by conferring, upon the one hand, a taxing power, and taking the same power away, on the other, by the limitations of the due process clause. *Treat v. White,* 181 U.S. 264; *Patton v. Brady,* 184 U.S. 608; *McCray v. United States,* 195 U.S. 27, 61; *Flint v. Stone Tracy Co.,* 220 U.S. 107, 158; *Billings v. United States,* 232 U.S. 261, 282. And no change in the situation here would arise even if it be conceded, as we think it must be, that this doctrine would have no application in a case where, although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property -- that is, a taking [240 U.S. 25] of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion. We say this because none of the propositions relied upon in the remotest degree presents such questions. It is true that it is elaborately insisted that, although there be no express constitutional provision prohibiting it, the progressive feature of the tax causes it to transcend the conception of all taxation and to be a mere arbitrary abuse of power which must be treated as wanting in due process. But the proposition disregards the fact that, in the very early history of the government, a progressive tax was imposed by Congress, and that such authority was exerted in some, if not all, of the various income taxes enacted prior to 1894 to which we have previously adverted. And over and above all this, the contention but disregards the further fact that its absolute want of foundation in reason was plainly pointed out in *Knowlton v. Moore,* 178 U.S. 41, and the right to urge it was necessarily foreclosed by the ruling in that case made. In this situation, it is, of course, superfluous to say that arguments as to the expediency of levying such taxes, or of the economic mistake or wrong involved in their imposition, are beyond judicial cognizance. Besides this demonstration of the want of merit in the contention based upon the progressive feature of the tax, the error in the others is equally well established either by prior decisions or by the adequate bases for classification which are apparent on the face of the assailed provisions; that is, the distinction between individuals and corporations, the difference between various kinds of corporations, etc., etc. *Knowlton v. Moore, supra; Flint v. Stone Tracy Co., supra; Billings v. United States, supra; National Bank v. Commonwealth,* 9 Wall. 353; *National Safe Deposit Co. v. Illinois,* 232 U.S. 58, 70. In fact, comprehensively surveying all the contentions [240 U.S. 26] relied upon, aside from the erroneous construction of the Amendment which we have previously disposed of, we cannot escape the conclusion that they all rest upon the mistaken theory that, although there be differences between the subjects taxed, to differently tax them transcends the limit of taxation and amounts to a want of due process, and that, where a tax levied is believed by one who resists its enforcement to be wanting in wisdom and to operate injustice, from that fact in the nature of things there arises a want of due process of law and a resulting authority in the judiciary to exceed its powers and correct what is assumed to be mistaken or unwise exertions by the legislative authority of its lawful powers, even although there be no semblance of warrant in the Constitution for so doing.

We have not referred to a contention that, because certain administrative powers to enforce the act were conferred by the statute upon the Secretary of the Treasury, therefore it was void as unwarrantedly delegating legislative authority, because we think to state the proposition is to answer it. *Field v. Clark,* 143 U.S. 649; *Buttfield v. Stranahan,* 192 U.S. 470, 496; *Oceanic Steam Navigation Co. v. Stranahan,* 214 U.S. 320.

Affirmed.

Supreme Court of Arkansas.

SIMS, STATE COMPTROLLER,
v.
AHRENS ET AL.

No. 114.

Jan. 19, 1925.
On Rehearing, May 4, 1925.
Rehearing Denied May 18, 1925.

Appeal from Pulaski Chancery Court; Jno. E. Martineau, Chancellor.

Suit by J. E. Ahrens and others against M. E. Sims, State Comptroller. Decree for plaintiffs, and defendant appeals. Affirmed.

McCulloch, C. J., and Smith, J., dissenting.

West Headnotes

Taxation ⚷25
371k25

Legislature has all power not denied by Constitution. Per Smith, J., and McCulloch, C. J.

Taxation ⚷26
371k26

Legislature may select subjects of taxes and classify them under Constitution. Per Hart and Humphreys, JJ.

Licenses ⚷5
238k5

Taxation ⚷37
371k37

Constitutional limitations on power of state to raise revenue for state purposes enumerated. Per Wood, J.

Taxation ⚷40(1)
371k40(1)

Scope of rule of "uniformity" stated. Per Hart and Humphreys, JJ.

Taxation ⚷932
371k932

Income tax *held* "exercise tax," not prohibited by Constitution.

Taxation ⚷933.1
371k933.1
(Formerly 371k933)

Legislature may enact properly classified net income law.

Taxation ⚷933.1
371k933.1
(Formerly 371k933)

Income tax *held* "excise tax," not prohibited by Constitution.

Taxation ⚷955
371k955

Gross income tax *held* unconstitutional.

Licenses ⚷5
238k5

State cannot tax occupation for state revenue purposes. Per Smith, J., and McCulloch, C. J.

Licenses ⚷5
238k5

Privileges and occupations of common right *held* not subject to taxation. Per Wood, J.

Licenses ⚷7(1)
238k7(1)

Income tax *held* invalid as occupation tax. Per Smith, J., and McCulloch, C. J.
***720** J. S. Utley, Atty. Gen., and Wm. T. Hammock, Asst. Atty. Gen., for appellant.

***721** J. C. Marshall, of Little Rock, for appellees.

Archer Wheatley, Basil Baker, Arthur L. Adams, and Horace Sloan, all of Jonesboro, amici curiae.

SMITH, J.

This appeal involves the constitutionality of Act 345 of the Acts of the General Assembly of 1923. Gen. Acts 1923, p. 282.

The title to this act is as follows:

"An act to be entitled an act to levy a sale or gross income tax of one-tenth of one percentum or one dollar ($1.00) on each one thousand ($1,000.00) dollars on the gross incomes of every resident of the state of Arkansas, and by natural persons not residents of this state who shall have received one thousand dollars or more per annum from and after March 31, 1923, to be levied and collected annually beginning April 1, 1924, for the sole use and benefit of the public schools of Arkansas and for other purposes."

A portion of section 1 of this act reads as follows:

"A tax is hereby imposed upon every resident of the state of Arkansas, which shall be levied, collected and paid annually upon and with respect to his or her entire gross income as herein defined at rates as follows: One-tenth of one per centum or one dollar on each one thousand dollars, and at that rate of one- tenth of one per cent. on each and every dollar over and above one thousand dollars from the gross income from all property owned and from every business, trade, profession or occupation, carried on in this state, and a like tax is hereby imposed and shall be levied and collected and paid annually to the State Comptroller of this state by natural persons not residents of this state."

Section 2 of the act defines the term "gross income," as employed in section 1 of the act. as follows:

"The term 'gross income': Includes gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; 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, including gains or profits or income derived through estates or trusts by the beneficiaries thereof, whether as distributed or as distributable shares, income from property acquired by gift, bequest, devise or descent. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer."

The appellees in this case--who were the plaintiffs below--are residents and citizens of this state, and have earned incomes upon which they will be required to pay taxes, if the act under review is valid. The income of one plaintiff had been earned as a manager of an insurance company; that of another from rents received on real estate; a third earned wages as a locomotive engineer; while the fourth had derived profits from his business as a merchant; and these plaintiffs seek by this suit to enjoin the state comptroller from attempting to enforce the payment of the tax imposed by Act 345 on their respective incomes. The court below held the act unconstitutional, and granted the relief prayed, and this appeal is prosecuted to reverse that decree.

It is quite obvious that the incomes of the plaintiffs are subject to the tax, if the act itself is valid. The act is all-comprehending. It includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid. It includes income derived from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of, or interest in, such property. It includes also incomes from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits. And, after thus including all apparent sources of income, there was added, out of a superabundance of caution that no source of income might be overlooked, the inclusive words, "and income derived from any source whatever."

[1][2] The tax authorized by this act, whatever else may be said of it, is both an occupation tax and an income tax, because income derived from all pursuits or callings are taxed, except certain exempted income enumerated in section 4 of the act, and which need not be recited here.

It is not a privilege tax, and cannot be sustained as such, because no attempt is made to distinguish between occupations which are of common right and those which might be designated as privileges and taxed as such. All are alike subject to the tax.

The act makes no attempt to restrict the imposition of the tax to such occupations as might be taxed as privileges, but imposes the tax as a unit on the entire income of every person subject to its provisions without regard to the source of the income, and the act must, therefore, stand or fall in its entirety, as its provisions are not separable. The act proposes a scheme of taxation which is either valid or void, as no separation of the sources of the income was contemplated by the Legislature. Oliver v. Southern Trust Co., 138 Ark. 389, 212 S. W. 77; Nixon v. Allen, 150 Ark. 244, 234 S. W. 45.

The tax in question is a state tax, and is levied for the use and benefit of the public schools of the state, and the first question presented is whether the state can levy such a tax for any state purpose. If the conclusion is reached that such a tax cannot be ***722** levied for state purposes, it will be unnecessary to consider any of the other objections interposed to the act.

In approaching the consideration of this question, it may be said that we do not have to search the Constitution for express authority to levy the tax. The power to levy it exists as an inherent right, unless the Constitution has denied the right to the state to levy taxes of this character.

The question is by no means new in this state. The question arose very early in the history of the state, and was first decided in the case of Stevens and Woods v. State, 2 Ark. 291, 35 Am. Dec. 72, and was considered in other early cases. We do not stop to review these cases, but will first consider the case of Baker v. State, 44 Ark. 134, because it was the first case to arise under our present Constitution, and these earlier cases were there reviewed.

In the case of Baker v. State, supra, the appellant had been indicted for "unlawfully engaging in business as an agent for the sale of sewing machines," without obtaining the license required by the act which he was charged with having violated. It was pointed out in the Baker Case that there was some apparent conflict in the early cases on this subject, and on that account the court was urged to take the subject up anew, and consider it de novo; but the court declined to do this for the reason, there stated, that this confusion had been recognized and considered in the case of Washington v. State, 13 Ark. 752, and the earlier cases were there reconciled; Chief Justice Cockrill, in delivering the opinion in the Baker Case, said:

"In an attempt to extricate itself from this difficulty, the court held [in the Washington Case] that there was no restraint upon the power of the Legislature to authorize counties and towns to regulate or tax callings and pursuits, but there was a restriction in that regard upon legislation for the purpose of raising a state revenue. This distinction has never been questioned by this court, but has been recognized and approved from time to time. McGee v. Mathis, 21 Ark. 40; Straub v. Gordon, 27 Id. 625; Barton v. City of Little Rock, 33 Id. 442; City of Little Rock v. Board, etc., 42 Id. 160."

After recognizing the Washington Case as having definitely decided the question that the Legislature might authorize counties and towns to regulate or tax callings or pursuits for the purpose of raising revenue, but that there was a restriction in that regard upon legislation for the purpose of raising state revenue, Chief Justice Cockrill took occasion to say that the decisions reviewed did not limit the power of legislation for state purposes to the taxing of such privileges as were technically known as such at the common law, that is to say, that the Legislature has a discretion to adjudge what are privileges, and such callings and pursuits as may be classed as privileges may be taxed for state purposes, but the court there clearly decided that unless a particular calling or pursuit might be classed as a privilege it was not subject to taxation for state purposes.

Upon the authority of the case of Baker v. State, supra, this court has consistently held that cities and towns may, when so authorized by the Legislature, tax callings and pursuits to raise revenue for municipal purposes, such taxes being commonly designated as occupation taxes. Among other cases in which it was so held are City of Little Rock v. Prather, 46 Ark. 471; Fort Smith v. Scruggs, 70 Ark. 549, 69 S. W. 679, 58 L. R. A. 921, 91 Am. St. Rep. 100; Laprairie v. City of Hot Springs, 124 Ark. 346, 187 S. W. 442; Davies v. Hot Springs, 141 Ark. 521, 217 S. W. 769; Pine Bluff Transfer Co. v. Nichol, 140 Ark. 320, 215 S. W. 579.

And upon the authority of Baker v. State, supra, this court has, with equal consistency, held that the state could not impose such taxes for state purposes. Among the cases so holding are State v. Washmood, 58 Ark. 609, 26 S. W. 11; Standard Oil Co. v.

Brodie, 153 Ark. 114, 239 S. W. 753; State v. Handlin, 100 Ark. 175, 139 S. W. 1112.

The reason for the distinction uniformly drawn by this court for upholding the tax in one case, and for declaring it invalid in the other, goes back to the Washington Case, supra, where the apparent conflict in the still earlier cases was reconciled, as Judge Cockrill said in the Baker Case, and the reason upon which the reconciliation of the cases was made was simply this: The Constitution had taken away from the state the right to tax occupations, which are of common right, for state purposes, and had left the state the right to tax only those callings or pursuits which might be classed as privileges, whereas no such limitation had been placed against the cities and towns.

The state might tax callings and occupations which are of common right had the Constitution not denied the state this power; but the Legislature has the right to confer this power on the cities and towns of the state, because the right to do so has not been withheld by the Constitution.

It was just here that this court in the Washington Case, speaking through Watkins, Chief Justice, reconciled the apparent conflict in the earlier cases. The decision in the Washington Case was rendered while the state's first Constitution--that of 1836--was in force.

Section 2 of the article on revenue in article 7 in the Constitution of 1836 reads as follows:

> "All property subject to taxation shall be taxed according to its value, that value to be ascertained in such manner as the General Assembly shall direct, making the same equal and uniform throughout the state. No one species of property, from which a tax may be collected, shall be taxed higher than another species of ***723** property of equal value. Provided, the General Assembly shall have power to tax merchants, hawkers, peddlers and privileges in such manner as may, from time to time, be prescribed by law."

It is quite obvious that this is substantially the same as section 5 of article 16 of our present Constitution, except that section 5 of article 16 of the present Constitution, after declaring the basis of taxation and the privileges which might be taxed, also enumerated the classes of property which should be exempt from taxation. The portion of section 5 of article 16 of the present Constitution relevant to the decision of the question here under consideration reads as follows:

> "All property subject to taxation shall be taxed according to its value, that value to be ascertained in such manner as the General Assembly shall direct, making the same equal and uniform throughout the state. No one species of property, from which a tax may be collected, shall be taxed higher than another species of property of equal value, provided the General Assembly shall have power from time to time to tax hawkers, peddlers, ferries, exhibitions and privileges in such manner as may be deemed proper."

A comparison of this section with the one quoted from the Constitution of 1836 shows that one was taken from the other, the difference being that the Constitution of 1836 included merchants, whereas the Constitution of 1874 does not include merchants; and the Constitution of 1836 did not include ferries or exhibitions, whereas the Constitution of 1874 does include them.

These are the provisions of the Constitution of 1836 which the court had under consideration when Chief Justice Watkins said for the court in the Washington Case:

> "But the imposition of taxes, granting of licenses by counties or towns, may be authorized or regulated by legislation, and that legislation is not necessarily controlled or limited by the provisions of the Constitution in regard to state revenues."

[3] This conclusion resulted from the rule of construction first adopted by this court in the case of State v. Ashley, 1 Ark. 513, and since continuously followed by this court in the construction both of the Constitution and of statutes, that the expression of one thing in the Constitution is the exclusion of another, and as was also said in Colby v. Lawson, 5 Ark. 303, quoting from State v. Ashley, supra, there are two ways of imposing a constitutional restriction, viz. by express negation and by affirmation, which implies a negation.

The Constitution defined what might be taxed by the state, and thus excluded what was not enumerated. No such limitation was imposed on the right to tax for county or municipal purposes, and the Legislature may, therefore, confer this right on the counties and municipalities of the state.

The question here involved was again considered by this court in the case of State v. Washmood, 58 Ark. 609, 26 S. W. 11, where Chief Justice Bunn, speaking for a unanimous court, said:

"If the tax was intended to be a tax levied upon the association or companies represented by the agents named, the question of the validity of the section would, at least, be an open one, but one which it is unnecessary for us to discuss in this connection. If, however, the intention of the Legislature, in enacting said section 5591, was to impose a tax upon the agent therein named, the tax would be an occupation tax, and, being a state tax, as expressed, it would be in violation of the Constitution of the state, as has been settled by numerous decisions of this court. [Citing cases.]"

The court then proceeded to consider whether the tax there sought to be enforced had been imposed upon the associations and companies for the privilege of carrying on their business in the state, or was intended as a tax upon the agents of such associations and companies; and having reached the conclusion that the tax which the appellant in that case was resisting was not a tax upon the right of the companies to carry on their business in this state, but upon the agent of the company, the court said:

"It was, therefore, an occupation tax, and, being a state tax also, the section authorizing it is in conflict with the Constitution."

In the case of Standard Oil Co. of Louisiana v. Brodie, 153 Ark. 114, 239 S. W. 753, the principles involved in this case were again under consideration. In that case a tax had been imposed on the sale of gasoline, and we there said:

"It is conceded in all quarters that if the imposition [of the tax on gasoline] is, in effect, a property tax it is void."

The tax was upheld, and in doing so we there further said:

"It is easy to discover in the language [of the act] an intention on the part of the lawmakers to impose a tax, not on property, but on a privilege, so as to bring the enactment within constitutional limits. The tax is not imposed on the sale or purchase of gasoline, nor on the gasoline itself, nor even on the use of the gasoline. On the contrary, the final and essential element in the imposition of the tax is that the gasoline purchased must be used in propelling a certain kind of vehicle over the public highways. In the final analysis of this language it comes down to the point that the thing which is really taxed is the use of the vehicle of the character described upon the public highway, and the extent of the use is measured by the quantity of fuel consumed, and the tax is imposed according to the extent of the use as thus measured."

In this Brodie Case we again reviewed the Washington and the Baker Cases, supra, and of the Washington Case we there said:

***724** "The substance of that decision is that the constitutional provision mentioned is a restriction upon the power of taxation of privileges, and that it does not authorize taxation upon a privilege which was a common right of every citizen," for state purposes.

And upon the review of the Baker Case we there said:

"We understand the effect of this decision to be that the restriction is not to the privileges specifically mentioned in the Constitution, nor privileges which were 'technically known as such at the common law,' but that the restriction relates merely to privileges which were matters of common right. This being true, there is nothing in the provision of the Constitution referred to which prohibits taxation for state purposes of the use of the public roads. While the public highways are for the common use of all, they belong to the public, and it is within the power of the Legislature either to regulate or to tax the privilege of using them. This power was declared in express terms by Judge Riddick in the Scruggs Case, supra."

These decisions apparently settled the law as definitely as repeated decisions of the same question can settle anything, that the state cannot tax, for revenue purposes, occupations which are of common right; but it is said that the case of Floyd v. Miller Lumber Co., 160 Ark. 17, 254 S. W. 450, 32 A. L. R. 811, unsettled those decisions and gave a new interpretation to the section of the Constitution quoted above. Has this been done?

It may well be said that the decision in the Floyd Case is somewhat anomalous, but the apparent anomaly results from the fact that the justices participating in the decision of the case entertained views which were conflicting, and which they were unable to reconcile. Such a result is always unfortunate, but is not always avoidable, and there are a number of such cases in our own reports as well as in those of all other appellate courts. A recent example of this kind is the case of Mashburn v. North Ark. Road Imp. Dist. (Ark.) 266 S. W. 964.

There were four opinions in the Floyd Case--one by Justice Humphreys; another by the Chief Justice, in which this writer concurred; a third by Justice Hart; and a dissenting opinion by Justice Wood.

These opinions expressed views which were so conflicting that they could not be reconciled, and it takes a consideration of them all to determine what was decided in that case. It may be said that the opinion was a composite one, and to extract the points decided it is necessary to determine what points were agreed upon for the different reasons expressed by the respective judges. The only point expressly decided by a constitutional majority of the court was that the tax--a severance tax--was not a property tax.

The opinion delivered by Justice Humphreys was a sweeping one, and the effect of his view was that the state could tax any occupation which the Legislature saw fit to make taxable. He applied to such tax the rule announced by Justice Riddick for this court in the case of Fort Smith v. Scruggs, 70 Ark. 549, 69 S. W. 679, 58 L. R. A. 921, 91 Am. St. Rep. 100, and it must be conceded that under his view a fair income tax would be constitutional. But that view was not accepted by the majority of the court.

In the opinion of the Chief Justice he reviewed the decisions of this court in the cases of Washington v. State, Baker v. State, State v. Washmood, and Standard Oil Co. v. Brodie, and the review of these cases was summarized by him as follows:

"The effect of these decisions undoubtedly is that the state cannot tax occupations generally, but must find its power to tax outside of this restriction. The power was found in the Baker Case and in the gasoline case in the right to tax the franchise of corporations as a privilege tax and to tax the use of public highways. Whether or not other exceptions outside of the constitutional restriction can be found remains to be seen in the future. I am unable to discover any ground for taking the operation of this statute, as applied to individuals, out of the restrictions prescribed in the Constitution."

After thus declaring himself, the Chief Justice took up the interpretation of the Scruggs Case as announced in the opinion of Justice Humphreys and said:

"The opinion of Judge Riddick in Fort Smith v. Scruggs, 70 Ark. 549, affords no support to the view that the Legislature can impose, for state revenue purposes, a tax on occupations. That was a case where the tax was imposed by a municipality, and it is undisputed that the state may delegate to counties and municipalities the power to levy any tax not prohibited by the Constitution. Baker v. State, supra. The business of severing timber or minerals from the soil for commercial purposes is purely an occupation, and the state cannot tax it as against individuals. Timber and minerals attached to the soil are individual property, as much so as anything else, and the business of severing for commercial purposes is a lawful business, of the pursuit of which no individual can be deprived. Therefore it falls within the restriction found in the Constitution. Penn. Coal Co. v. Mahon, 260 U. S. 393."

After announcing this view of the law, the Chief Justice expressed the opinion that the statute there under review could be upheld against corporations as being in the nature of a tax on the franchise of the corporations engaged in the occupations there taxed.

Justice Hart, for reasons which he there fully stated and which need not be recopied ***725** here, reached the conclusion that the tax was valid against both individuals and corporations. He stated that through the development of a country occupations which had been of common right might cease to be such and might become proper subjects for regulation by the state in the exercise of its police power, and announced his final conclusion in the following language:

"Upon further consideration of the case, upon rehearing, I have reached the conclusion that the occupations taxed in the act may be termed privileges under the common law and taxed as such under our Constitution. There has been no precise limit to the police power of the state, as construed by this court."

Had the entire court reached the view announced by Justice Hart, in summing up his views, the decision would have been a unanimous one, and most of what was said by the various judges would have been obiter, as there was, and is, no difference of opinion about the right of the state to tax privileges for state purposes, the conflict of opinion arose over the question whether the business of severing products from the soil constituted a privilege.

In his dissenting opinion, Justice Wood recited that in certain states it had been held that--

"a privilege is whatever business, pursuit, occupation or vocation affecting the public the Legislature chooses to declare and tax as such."

After mentioning cases so holding he proceeded to say:

"Our court, from a very early period in its history, has taken a different view, by holding that it is not within the power of the Legislature, under our Constitution, to declare and tax as a privilege, for state revenue, those pursuits and occupations which every one may follow as a matter of common right. The doctrine of our court is that these pursuits and occupations which are matters of common right cannot be taxed as privileges for state revenue. It is within the power of the Legislature, under our Constitution, to authorize counties and towns to regulate or tax callings and pursuits, but this cannot be done by towns or counties for the purpose of raising state revenue, nor by the Legislature itself for that purpose. Of course, if pursuits or occupations which are matters of common right are conducted in a manner which injuriously affects the public interest, they may be required to pay a license tax for purposes of regulation under the police power. See Stevens v. State, 2 Ark. 291; Gibson v. Pulaski County, 2 Ark. 209; Washington v. State, 13 Ark. 752; McGehee v. Mathis, 21 Ark. 40; Straub v. Gordon, 27 Ark. 625; Barton v. Little Rock, 33 Ark. 442; Little Rock v. Board, 42 Ark. 160; Baker v. State, 44 Ark. 134; State v. Washmood, 58 Ark. 609. Under the doctrine of stare decisis, these cases have become the settled law of this state, and, until they are overruled, which up to this hour has not been done, this court cannot consistently hold that it is within the power of the Legislature to declare and tax as privileges, for state revenue, pursuits and occupations which are matters of common right. To so hold would be to overrule all these cases, and, if they are to be overruled at all, it should be done expressly, and not by implication. Therefore, even if the tax under review were an occupation tax, it would be unconstitutional and void, under these numerous decisions of our court."

In view of these expressions of opinion appearing in the case of Floyd v. Miller Lumber Co., we think it cannot be said that the cases of Washington v. State, Baker v. State, State v. Washmood, and Standard Oil Co. v. Brodie, supra, have been overruled or their authority impaired by the case of Floyd v. Miller Lumber Co.; and unless they have been overruled, the state is without power to impose either an income or occupation tax for state purposes, and the court below was, therefore, correct in holding that act unconstitutional, and that decree is affirmed.

We, Justices HART and HUMPHREYS, concur in the judgment, because we think the present income tax statute unconstitutional, but we dissent from the majority opinion that a proper net income tax is unconstitutional.

HART, J.

Judge HUMPHREYS and myself concur in the judgment, because we think that a gross income tax operating upon all persons and corporations alike is unconstitutional.

In Crew Levick Co. v. Pennsylvania, 245 U. S. 292, 38 S. Ct. 126, 62 L. Ed. 295, it was held that a state tax upon the business of selling goods in interstate commerce measured by a certain percentage of the gross transactions in such commerce, was by its necessary effect a tax upon the commerce.

In United States Glue Co. v. Town of Oak Creek, 247 U. S. 321, 38 S. Ct. 499, 62 L. Ed. 1135, Ann. Cas. 1918E, 748, it was held that the levy and assessment of a general income tax upon the net income of a Wisconsin corporation derived from transactions in interstate commerce is not such a direct burden on interstate commerce as to contravene the commerce clause of the United States Constitution. Mr. Justice Pitney, who delivered the opinion of the court, said:

"The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude, and irrespective of whether it is profitable or otherwise. Conceivably, it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and ***726** losses, and the tax cannot be heavy unless the profits are large. Such a tax, when imposed upon net incomes from whatever source arising, is but a method of distributing the cost of government, like a tax upon property, or upon franchises treated as property; and, if there be no discrimination against interstate commerce, either in the admeasurement of the tax or in the means adopted for enforcing it, it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the states are not exempted by the federal Constitution because they happen to be engaged in commerce among the states."

Again in Shaffer v. Carter, 252 U. S. 37, 40 S. Ct. 221, 64 L. Ed. 445, and Travis v. Yale & Towne Mfg. Co., 252 U. S. 60, 40 S. Ct. 228, 64 L. Ed. 460, it was held that net income derived from interstate commerce is taxable under a state law providing for a general income tax.

The majority opinion is based wholly upon the assumption that occupation taxes levied for the privilege of carrying on a particular business, and a tax on the income from such business are the same thing.

"License and occupation taxes, which are payable in respect to the privilege of engaging in or carrying on a particular business are not income taxes, although the amount of the tax payable by any individual may be measured by the amount of business which he transacts on his earnings therefrom. And conversely, although a person's entire income may be derived from a particular pursuit or trade, a tax on the income as such is not a license or privilege tax." Black on Income and other Federal Taxes, section 3.

Thus a tax on sales of a particular commodity, or a tax on the dealer measured by the amount of his sales, is not an income tax. In the same section, the author further said:

"But a franchise tax upon corporations is not an income tax, although it may be called an excise tax. And this is so, whether the tax is laid by the state under whose laws the corporation is organized, and is exacted annually for the privilege of continuing its corporate existence, or is imposed by a different state for the privilege of doing business within its limits, or is imposed by an outside power, such as the United States, upon the franchise of transacting business in a corporate capacity. For this reason, the tax on corporations imposed by Congress in 1909, being laid specifically upon the carrying on or doing of business in a corporate or quasi corporate capacity, was adjudged not to be an income tax, although the amount of the tax in each instance was measured by the net annual income of the corporation, but an excise tax, not direct and therefore not invalid because not apportioned among the several states according to population," citing Flint v. Stone Tracy Co., 220 U. S. 107, 31 S. Ct. 342, 55 L. Ed. 389, Ann. Cas. 1912B, 1312.

We also quote from Cooley on Taxation (4th Ed.) vol. 4, § 1742, the following:

"An income tax is to be distinguished from an occupation tax, the amount of which depends upon the income. An excise upon those engaged in a particular occupation, although graded in accordance with income, is an occupation tax and not an income tax. So a tax on oyster tongmen on the amount of their sales is not an income tax. A franchise tax on corporations is not an income tax, although its amount is measured by the net annual income of the corporation. A tax on the gross receipts of a railroad is not an income tax."

In section 1743, Judge Cooley says that there is a considerable conflict of opinion as to whether an income tax should be classified as a property tax or an excise tax. Continuing, he said that, if they are to be deemed a property tax, constitutional limitations applicable to property taxes must be applied, thereby limiting the power of the Legislature. If they are excise taxes, such limitations are not applicable.

We think the adjudicated cases bear out the views expressed above. It must be admitted that the cases are in direct conflict, but the difference arises upon the question of whether under clauses of state Constitutions similar to the one in question an income tax is a property tax and therefore violates the uniformity clause, and not upon the fact that an income tax and occupation tax are one and the same thing. In all cases where it is held to be an excise and not a property tax, an income tax has been held to be valid.

In an early case Judge Lumpkin for the Supreme Court of the state of Georgia said that the Constitution which would confound income with property in a tax law was quite too refined and subtle, when designed to operate upon the public at large, and where they are supposed to be used in the sense belonging to the popular language of common life and everyday business. Mayor of Savannah v. Hartridge, 8 Ga. 23.

Again, in Waring v. Savannah, 60 Ga. 93, the Supreme Court of that state said:

"But are gross earnings and interest, coming in from any source, labor, capital * * * money loaned--are these things property in the sense of the Constitution, and to be taxed as real, genuine property--such as real estate and personal effects--or are these really income? Certainly the gross earnings of a laboring man are nothing but his income; so, it would seem, the earnings of a salaried officer are income; and so the income from capital employed in a bank, or railroad, or manufactory, would seem to be income only. The net income, after expenses are paid, becomes property when invested, or if it be money lying in a bank, or locked up at home. But, to call it property when it is all consumed as fast as it arises--going on the back, or in the stomach, or in carriages and horses (which are taxed), or in travel and frolic--to call such income, so used, property, would seem to be a perversion of terms."

***727** Continuing the court said:

"The fact is property is a tree; income is the fruit; labor is a tree; income, the fruit; capital, the tree; income, the fruit. The fruit, if not consumed as fast as it ripens, will germinate from the seed which it incloses, and will produce other trees, and grow into more property; but so long as it is fruit merely, and plucked to eat, and consumed in the eating, it is no tree, and will produce itself no fruit."

The precise point under consideration here under a substantially similar constitutional provision was presented to the Supreme Court of the state of Missouri in Glasgow v. Rowse, 43 Mo. 479. In deciding the question the court said:

"The power to tax rests upon necessity, and is inherent in every sovereignty. The Legislature of every state possesses it, whether particularly specified in the Constitution as a grant of power to be exercised or not. In reference to taxation, the Constitution is not so much to be regarded a grant of power as a restriction or limitation of power. That taxes should be uniform, and levied in proportion to the value of the property to be taxed, is so manifestly just that it commends itself to universal assent. But, notwithstanding the constitutional provision, there are some kinds of taxes that are not usually assessed according to the value of property, and some which could not be thus assessed; and there is, perhaps, not a state in this union, though many of them have in substance the same constitutional provision, which does not levy other taxes than those imposed on property. * * *

There are three general classes of direct taxes: Capitation, having effect solely upon persons; ad valorem, having effect solely upon property; and income, having a mixed effect upon persons and property."

"The argument of the plaintiff's counsel proceeds on the hypothesis that every species of tax comes within the constitutional prohibition. This is a mistake. The whole practice of the state has been different, and it has never been challenged, nor could it be, on legal principles.

The statutes provide for a poll tax, which is in violation of the ad valorem rule, and is unequal, yet it is clearly within the Constitution. A license is imposed on shows, peddlers, auctioneers, dramshops, and billiard tables, all of which taxes are in violation of the ad valorem principle, but not therefore unconstitutional. The taxes imposed are uniform as to the particular classes, but not in proportion to the taxes assessed on other property.

The Constitution enjoins a uniform rule as to the imposition of taxes on all property, but does not abridge the power of the Legislature to provide for a revenue from other sources. It was intended to make the burdens of government rest on all property alike--to forbid favoritism and prevent inequality. Outside of the constitutional restriction, the Legislature must be the sole judge of the propriety of taxation, and define the sources of revenue as the exigency of the occasion may require. The income tax was uniform and equal as to the classes upon whom it operated; it did not come within the meaning of the term 'property' as used and designated in the Constitution, and I think it was not in conflict with any provision of that instrument."

The same question was again presented to the Supreme Court of Missouri in Ludlow-Saylor Wire Co. v. Wollbrinck, 275 Mo. 339, 205 S. W. 196, and the reasoning and conclusion of the court in the earlier case was approved by a divided court. Able and instructive opinions were delivered both by the majority and dissenting judges.

On the other hand, in Eliasberg Bros. Mercantile Co. v. Grimes, 204 Ala. 492, 86 So. 56, 11 A. L. R. 300, the Supreme Court of Alabama held that income is property within the meaning of the constitutional provision limiting the tax rate to a certain percentage of the value of the taxable property within the state.

McClellan, J., a very able judge, dissented on the ground that the expended or exhausted part of the income of the earner is not property held or possessed by him in such manner as to be subject to a property tax.

The Supreme Court of Mississippi had the question for consideration in Hattiesburg Grocery Co. v. Robertson, 126 Miss. 34, 88 So. 4, 25 A. L. R. 748, and held that an income tax is an excise tax and not a tax on property within the meaning of the requirement of the provision of the state Constitution that property shall be taxed in proportion to its value, and shall be assessed for taxes under general laws and by uniform rules according to its true value.

The court said that "income" is the gain derived from capital, from labor, or from both combined, and that income for any given period of time is the amount of gain so derived during the designated period of time.

The court further said that, "while a tax on income includes some of the elements both of a tax on property and of a tax on persons, it cannot be strictly classified as a tax on either, for it is generically and necessarily an excise, and should be enforced as such, unless and until so to do" would violate the provision of the Constitution adopted to prevent discrimination in the taxation of property. On this point the court said that:

"The error in the cases * * * holding that an income tax must be classified as a tax on property results from dissociating gains derived from capital, or from labor, or from both, wholly from the activities relative thereto of the person taxed, and looking alone to the specific property which constitutes the gain so derived."

There was also a dissent in this case, but it was based upon the opinion that an income tax was a property tax. It is worthy of note that the reasoning of the dissenting opinion is based in part upon a previous decision of the court in Thompson v. McLeod, 112 Miss. 383, 73 So. 193, L. R. A. 1918C, p. 893, Ann. Cas. 1918A, p. 674. In that case it was held that a tax of a certain amount per cup or box for the privilege of carrying on the business of extracting turpentine from ***728** standing trees is a property tax within the constitutional provision that taxes shall be equal and uniform, and that property shall be taxed in proportion to its value, and that, when the land is already taxed, it is invalid as double taxation.

We cannot see how the majority opinion can find any support from any of the various opinions in Floyd v. Miller Lbr. Co., 160 Ark. 17, 254 S. W. 450, 32 A. L. R. 811, except, perhaps, that of Judge Wood, and there is an express disclaimer of going to the views expressed in his dissenting opinion to the effect that a tax levied upon the business of severing our natural resources from the soil was a property tax. Chief Justice McCulloch, in the concurring opinion of himself and Mr. Justice Smith, commenced his opinion with the declaration that our severance tax statute was not a property tax, but was a tax on a business--an occupation tax. While he expressed views that would lead to the belief that the statute was unconstitutional as to individuals, he wound up his opinion by stating that both he and Mr. Justice Smith voted to reverse the decree. This made the statute valid and operative as to individuals, for Mr. Justice Humphreys and myself had, for different reasons, expressed the view that the tax was an occupation and not a property tax, and was therefore valid as to individuals as well as corporations. This made four of the judges expressing the opinion that the tax was a tax on the business of severing our natural resources from the soil, and an occupation tax, and that it was a valid statute.

This view is in accord with Oliver Iron Co. v. Lord, 262 U. S. 172, 43 S. Ct. 526, 67 L. Ed. 929.

In that case a tax was laid on the business of mining iron ore, measured by a percentage of the value of the ore mined or produced. On the one hand it was contended that it was a property tax, and on the other that it was an occupation tax. The court said that a tax laid on those engaged in the business of mining ore, and on them solely because they are so engaged, was an occupation tax. So it would seem to result from our severance tax decision that a severance tax is an occupation and not a property tax, and therefore does not violate the provision of our Constitution that all property subject to taxation shall be taxed according to its value.

Our conclusion of the whole matter is that the effect of our previous decisions that the proviso in article 16, § 5, of the Constitution, giving the Legislature the power to tax certain occupations by necessary implication, precludes it from taxing other occupations for state purposes and that, if the provision had been left out of the section, the Legislature might have taxed all occupations. The section contains no such restriction as to income taxes. Hence, if we are correct in holding that an income tax is not a property tax, and if it is not the same thing as an occupation tax, it necessarily follows that it is within the discretion of the Legislature to pass a properly classified net income tax law. With the wisdom or necessity of an income tax law we have nothing to do. Such a law, if within constitutional lines, represents the public policy of the state in the matter, because it is passed by that branch of the state government which determines its economic policy, and which is restricted in its power in the matter only by a sense of duty and responsibility to the people.

Since writing the above, further consideration of the case has prompted me to write the following:

In Ouachita County v. Rumph, 43 Ark. 525, it was held that the right to impose taxes upon citizens and property for the support of the state government may be restricted by the Constitution, but needs no clause to confer it. The court said that by article 2, § 23, of the Constitution, the state's ancient right of taxation is fully and expressly conceded. But it is said that article 16, § 5, limits all taxation to taxes on property and certain occupations and privileges. Such view is contrary to the weight of authority.

In Cooley on Constitutional Limitations (7th Ed.) p. 713, in discussing the question it is said:

"It is evident, therefore, that the express provisions, which are usual in state Constitutions, that taxation upon property shall be according to value, do not include every species of taxation; and that all special cases like those we have here referred to are, by implication, excepted."

In Standard, etc., Co. v. Attorney General, 46 N. J. Eq. 270, 19 A. 733, 19 Am. St. Rep. 394, the court said:

"In those states in the Union having constitutional provisions requiring equality in the taxation of property, it is uniformly held that such provisions do not abridge or apply to the legislative power of indirect taxation by taxes on franchises, privileges, trades, and occupations."

In Fleetwood v. Read, 21 Wash. 547, 58 P. 665, 47 L. R. A. 205, the court said that under the great weight of authority a tax on occupation, business, etc, is not, in legal contemplation, a tax on property which falls within the inhibition imposed by the usual constitutional provisions in relation to uniformity of taxation. To the same effect see People v. Coleman, 4 Cal. 46, 60 Am. Dec. 581; Aulanier v. Governor, 1 Tex. 653; Bright v. McCullough, 27 Ind. 223, and In re Watson, 17 S. D. 486, 97 N. W. 463, 2 Ann. Cas. 321, and case note at 325.

In Baker v. Cincinnati, 11 Ohio St. 534, the court said that an express direction to impose a tax on all property by a uniform rule does not necessarily exclude taxation upon that which is not property, or cover the whole ground included within the limits of the taxing power. But it is claimed that the power ***729** to impose income taxes is excluded by necessary implication in the proviso allowing the taxation of certain named occupations and privileges, upon the principle that the expression of one thing excludes another. In discussing the application of this maxim in Eyre v. Jacob, 14 Grat. (Va.) 422, 73 Am. Dec. 367, the court said:

"But this argument would prove too much, for it would sweep away the taxes on deeds, suits, notarial seals, and that class of subjects the constitutionality of which has never been questioned by any one. It would restrict the whole power of taxation to the particular subjects named in the twenty-second and three following sections. But this, surely, could not have been designed by the framers of the Constitution. If those four sections had been entirely omitted, no one can doubt that the Legislature would have had full power to tax all the subjects to which they relate."

In that case it was held:

"Although Virginian Constitution provides that taxes shall be equal and uniform, it is within the constitutional power of the Legislature to impose a tax upon the transmission of estates by devise or descent, and prescribe the rate of the same."

In Jenkins v. Ewin, 8 Heisk. (Tenn.) 456, the court had under consideration a clause of the Constitution of the state of Tennessee in all essential respects similar to article 16, § 5, of our Constitution. The court said:

"This language would seem, at first view, to confer upon the Legislature the power to tax merchants, peddlers, and privileges. Its true object, however, was to indicate with distinctness that the power to tax merchants, peddlers, and privileges, was not to be understood as inhibited by the restriction as to the taxation of property. Its meaning is that, although in taxing property the Legislature is forbidden to tax it, except according to its value, yet as to merchants, peddlers, and privileges, the Legislature is not to be restricted, but may exercise the taxing power without restrictions, either as to the amount, or as to the manner or mode of exercising the power."

In this connection it may be stated that the Supreme Court of the state of Tennessee has held that a privilege is any occupation which the Legislature chooses to declare and tax as such. Burke v. Memphis, 94 Tenn. 692, 30 S. W. 742.

On the other hand, our court has restricted the meaning of the word "privileges" to those occupations which are not of common right. Hence, with better reason, we should hold that the proviso was placed in the section for the purpose of inhibiting the Legislature from taxing all occupations, and restricting its power of taxation for state purposes to those only which are expressly mentioned. Here is where the maxim, the expression of one thing excludes another, applies. We do not think the framers of the Constitution intended to exclude subjects of taxation which were not mentioned in the section. If income taxes and occupation taxes are not the same thing, it would seem reasonable to hold that a restriction as to the kind of occupations that may be taxed ought not to prohibit the Legislature in the exercise of the ancient right of the state to levy taxes from imposing income taxes unless such taxes are classed as property taxes. On this point I adhere to my former views. Our Constitution not only protects the life, liberty and property of the people, but protects them as well in respect to their occupations or means of support.

[4][5] It results from the authorities cited above that the Legislature may select the subjects of taxes and classify them under the Constitution. Taxes may be imposed on any subject in just proportion to the benefits and protection which such subject receives. The rule of uniformity does not require that all subjects be taxed, nor taxed alike. The requirement is complied with, when the tax is levied equally and uniformly on all subjects of the same class and kind. In doing this, some incomes might be exempted and those taxed may be classified. It is absolutely essential to uniformity that the net income only should be taxed. In business enterprises the profits are variable, and do not bear any fixed relation to the amount of capital invested. For the reason that the relation between the amount of capital and of profits varies widely, a tax on gross profits would necessarily operate in a discriminatory manner and be arbitrary. To illustrate: A merchant requires capital as a basis of his business operations, and his profits may be large or small as compared with the amount of his capital. Factors, brokers, insurance agents, and the like have but little capital invested, and their profits may be very large. If one spends his income as he makes it or it is consumed in the use, he pays but little or no property tax and escapes entirely in so far as the profits of his business are concerned, if an income tax be held unconstitutional; yet the protection afforded by the state is as important to him as to others, who must bear the burdens of taxation.

HUMPHREYS, J., concurs in this opinion.

On Rehearing.

WOOD, J.

[6] On the original consideration of this case, the entire court concurred in the conclusion that act No. 345 of the Acts of the General Assembly of 1923, commonly designated as the "Riggs Income Tax Law," violated the provisions of article 16, § 5, of our Constitution, and was therefore void. Mr. Justice SMITH, speaking for the majority of the

court, says:

"The act is all-comprehending. It includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid. It includes income derived from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, ***730** growing out of the ownership or use of or interest in such property. It includes also incomes from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits. And, after thus including all apparent sources of income, there was added, out of a superabundance of caution that no source of income might be overlooked, the inclusive words, and income derived from any source whatever."

"The tax authorized by this act, whatever else may be said of it, is an occupation tax and an income tax, because income derived from all pursuits or callings are taxed, except certain exempted incomes enumerated in section 4 of the act, and which need not be recited here.

It is not a privilege tax, and cannot be sustained as such, because no attempt is made to distinguish between occupations which are of common right and those which might be designated as privileges, and taxed as such. All are alike subject to the tax.

The act makes no attempt to restrict the imposition of the tax to such occupations as might be taxed as privileges, but imposes the tax as a unit on the entire income of every person subject to its provisions, without regard to the source of the income, and the act must therefore stand or fall in its entirety, as its provisions are not separable. The act proposes a scheme of taxation which is either valid or void, as no separation of the sources of the income was contemplated by the Legislature."

Judge SMITH then reviews all our previous decisions involving the question of whether or not it is within the power of the Legislature, under article 16, § 5, of our Constitution, to tax occupations which are of common right, and correctly announces the doctrine of these cases to be that "the state cannot tax for revenue purposes occupations which are of common right." And he concludes by saying, "Unless they have been overruled, the state is without power to impose an income tax for state purposes."

I concurred in the majority opinion. On reconsideration we are asked to modify the opinion and withdraw that part of it which declares that "the state is without power to impose an income tax for state purposes."

Now, if an income tax is neither a property tax nor a tax on pursuits and occupations that are of common right, then an income tax law, if properly framed, is not inhibited by article 16, § 5, supra, which provides that "all property subject to taxation shall be taxed according to its value" ascertained in a manner to make it "equal and uniform throughout the state," and that "hawkers, peddlers, ferries, exhibitions and privileges" may be taxed in such manner as the Legislature deems proper.

[7] After a careful consideration of the authorities cited in all the briefs of counsel, as well as the authorities cited in the dissenting opinion of Justices HART and HUMPHREYS and such other cases as I have been able to review, I have reached the conclusion that an income tax is neither a property tax, nor a tax on occupations of common right, and that such a tax is not inhibited by the provisions of article 16, § 5, of our Constitution above quoted. Judge HART, in his dissenting opinion, has quoted quite freely from the case of Glasgow v. Rowse, 43 Mo. 479, and Hattiesburg Grocery Co. v. Robertson, 126 Miss. 34, 88 So. 4, 25 A. L. R. 748, and other cases, and he also cites the later case of Ludlow-Saylor Wire Co. v. Wollbrinck, 275 Mo. 339, 205 S. W. 196, in which the Supreme Court of Missouri, by a divided court, sustained its earlier decision in Glasgow v. Rowse, supra; the opinion of the majority being written by Chief Justice Bond. The provisions of the Constitution of Mississippi (article 4, § 112), and of the Constitution of Missouri (article 10, §§ 3 and 4), concerning the taxation of property, are of the same purport as our own Constitution.

I cannot hope, by any argument of my own, to add force and strength to the argument of Judges HART and HUMPHREYS and of the judges rendering the opinions in the above cases. Suffice it to say that I am convinced from these opinions and the authorities cited therein that, in the general classification of taxes into property, capitation, and excise taxes, an income tax falls within the latter class--that of excise taxes. As is well said in Hattiesburg Grocery Co. v. Robertson, supra: "Income is necessarily the product of the joint efforts of the state and the recipient of the income, the state furnishing the protection necessary to enable the recipient to produce, receive, and enjoy it, and a tax thereon in the last analysis is simply a portion cut from the income and appropriated by the state as its share thereof, and, while a tax on income includes some of the elements both of a tax on property and of a tax on persons, it cannot be classified as strictly a tax on either, for it is generically and necessarily an excise, and should be enforced as such, unless and until so to do would accomplish the result which section 112 of the Constitution was adopted to prevent, which is to prevent discrimination in the taxation of property, so that all property shall bear its due proportion of the burdens of government."

The leading case cited in all the cases holding that an income derived from real and personal property is itself property is that of Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429, 15 S. Ct. 673, 39 L. Ed. 759, and 158 U. S. 601, 15 S. Ct. 912, 39 L. Ed. 1108. I have heretofore considered the Pollock Case, supra, as complete and ultimate authority for holding that an income tax is a property tax. But attention is called in the case of Hattiesburg Gro. Co. v. Robertson, supra, to the case of Brushaber v. Union Pacific Ry. Co., 240 U. S. 1, 36 S. Ct. 236, 60 L. Ed. 493, L. R. A. 1917D, 414, Ann. Cas. 1917B, 713, in which Chief Justice White, speaking for the entire court, of the holding in the Pollock Case, said:

"The conclusion reached in the Pollock Case did not in any degree involve holding that income ***731** taxes generically and necessarily came within the class of direct taxes on property, but, on the contrary, recognized the fact that taxation on income was in its nature an excise entitled to be enforced as such unless and until it was concluded that to enforce it would amount to accomplishing the result which the requirement as to apportionment of direct taxation was adopted to prevent, in which case the duty would arise to disregard form and consider substance alone, and hence subject the tax to the regulation as to apportionment which otherwise as an excise would not apply to it. Nothing could serve to make this clearer than to recall that in the Pollock Case, in so far as the law taxed incomes from other classes of property than real estate and invested personal property, that is, income from 'professions, trades, employments, or vocations' * * * its validity was recognized; indeed, it was expressly declared that no dispute was made upon that subject, and attention was called to the fact that taxes on such income had been sustained as excise taxes in the past. * * * The whole law was, however, declared unconstitutional on the ground that to permit it to thus operate would relieve real estate and invested personal property from taxation and 'would leave the burden of the tax to be borne by professions, trades, employments, or vocations; and in that way what was intended as a tax on capital would remain, in substance, a tax on occupations and labor,' * * * a result which it was held could not have been contemplated by Congress."

It is this language of Chief Justice White interpreting Pollock v. Farmers' Loan & Trust Co., supra, not quoted by Judge HART in his dissenting opinion, that I now wish to stress, because it shows that an income tax in its essential nature is not a property tax, but an excise tax. [FN1]

FN1. The celebrated case of Pollock v. Farmers' Loan & Trust Co. covers 339 pages of the reports. The opinions therein are models of judicial industry and thoroughness. They show that the judges gave the case the consideration its transcendent importance demanded, and are notable contributions to Anglo Saxon Jurisprudence, on the subject of income tax law. But I wish especially to call attention to the dissenting opinions of Justices White and Harlan. These are the most exhaustive, learned, forceful, and illuminating, judicial pronouncements on the particular subject of income tax to be found in all the realm of the adjudicated law. They show, conclusively, it seems to me, that under our American system-- our federal, and state Constitutions and statutes--a tax on incomes cannot properly be classified as a property tax, but falls in the class of excise taxes.

The author of Cooley on Taxation says:

"An excise tax, using the term in its broad meaning as opposed to a property tax, includes taxes sometimes designated by statute or referred to as privilege taxes, license taxes, occupation taxes, and business taxes. * * * Generally the term 'excise taxes' is used to distinguish such taxes from taxes on property. It is often very important to determine whether a certain tax is a property tax or an excise tax, i. e., whether (1) a property tax or (2) an occupation, license, business, privilege, or franchise tax. Not only are excise taxes governed by many rules entirely different from those which control property taxation, but also there are many constitutional provisions applicable to taxes on property but not to excise taxes. For instance, an excise tax is not within constitutional prohibitions such as those requiring taxation of property by value, uniformity, and equality of taxation. So such a tax is not objectionable as double taxation although the property itself is also taxed." Cooley on Taxation, vol. 1 (4th Ed.) §§ 45 and 46.

After stating that it is settled that a federal income tax is an excise tax, he further says:

"In regard to state income taxes, the law is not so clear; generally, however, it has been held that such a tax is not a tax on property, or, at least, is not such a tax as to be included in the constitutional limitations imposed on property taxes."

And further:

"The better rule seems to be that an income tax is not a tax on property within a constitutional requirement that taxation on property shall be in proportion to its value." Sections 1743-1751.

Mr. Black says:

"A tax on incomes is not a tax on property, and a tax on property does not embrace incomes. * * * For the same reason, a tax laid on income is different from a tax laid on the property out of which the income arises. * * *" Black on Income and Other Federal Taxes (4th Ed.) § 2.

In 37 Cyc. § 6, p. 759, it is said:

"A tax may be levied on income derived from property, in the shape of rent or otherwise, although the property yielding the income is also subjected to taxation; and this does not violate the rule against double taxation, because the two interests or species of property are distinct and severable."

The author of the article from which the above quotation is made is Henry Campbell Black. I may say, en passant, that I deem it entirely safe to follow such an illustrious judge as the late Chief Justice White and such an eminent text-writer as Henry Campbell Black.

In the cases of Glasgow v. Rowse and Ludlow-Saylor Wire Co. v. Wollbrinck, supra, the Supreme Court of Missouri held, quoting from the latter case, that:

"In directing, as the Constitution does, that taxes on property should be levied according to value, reference was intended to be made to other species of property than that which a person has in his income; that the Constitution did not abridge the power of the Legislature to provide revenue by a taxation of income; that its command was directed to other and distinct classes of property, which on account of their peculiar nature could be measured in value, become the object of taxation independent of the owner, and were susceptible, by proper procedure, to lien or seizure for the enforcement of the tax. The court held that it was property having such a nature and characteristics, and not the mere usufruct of ***732** such property, nor the earnings of physical or mental labor, which was referred to in the clause under review, and intended thereby to be subjected to taxation according to its value."

In the case of Floyd v. Miller Lumber Co., 160 Ark. 17-46, 251 S. W. 450, 460 (32 A. L. R. 811), in construing what is commonly known as the severance tax act, among other things, I said:

"Since the act levies a tax on the business of 'severing from the soil or water, for commercial purposes, natural resources,' it lays upon the owners of such resources a tax burden which restricts them from the free enjoyment and use of these resources, from the only possible use they can make of their property. It deprives them of a common right, which they had under all our previous decisions, even down to Standard Oil Co. v. Brodie, 153 Ark. 114."

Then I quoted from the case of Thompson v. Kreutzer, 112 Miss. 165, 72 So. 891, and cited the case of Thompson v. McLeod, 112 Miss. 383, 73 So. 193, L. R. A. 1918C, 893, Ann. Cas. 1918A, 674, and also Dawson v. Ky. Distilleries Co., 255 U. S. 288, 41 S. Ct. 272, 65 L. Ed. 638. The Supreme Court of Mississippi says that there is no conflict in the above cases with its holding in the case of Hattiesburg Grocery Co. v. Robertson, supra, the distinction being that in the former cases the tax was on the right to own and use property, whereas in the Hattiesburg Grocery Co. Case the tax was on the "income" from and not on the right to own and use property. In my dissenting opinion in the severance tax case and in the cases I there cited, the tax was condemned because it was a tax on the right to own and use property and therefore a property tax.

In the recent case of Replogle v. City of Little Rock, 267 S. W. 353, we said:

"Under our state and federal Constitutions all men have the inalienable right to acquire, possess, and protect property, and to pursue their own happiness, and of these sacred rights no man can be deprived without due process of law."

But a tax on the right to own and enjoy the use of property is one thing, while a tax on the income derived from such use is an entirely different thing. A tax, whether prohibitive or restrictive, on the right of ownership and use is forbidden, but a tax on the income derived from the use of property is allowed. If one were not guaranteed the right to acquire, own, and use property, then there would be no property and no income therefrom to tax. But, where one is allowed to own and use property and derives an income therefrom, such income may be taxed, and such a tax is not a tax on the property which produces the income, but is a tax on the income, and therefore such a tax does not come within the constitutional restrictions and limitations applicable to property taxes, i. e., that such taxes must be ad valorem, equal, and uniform.

To my mind the distinction is very clear between a tax on the right to own and use property--which is a tax on the property itself--and a tax on the income thereof which is the product of such ownership and use. The term "income" in constitutional and statutory provisions in regard to taxation means net gain derived from capital, or labor, or from both combined, during the fiscal year or period set apart by the taxing power for its ascertainment. The word "income" as used for taxation purposes "involves time as an essential element in its measurement or definition, and thus differs from capital, which commonly means the amount of wealth which a person has on a fixed date. Income may be derived from capital invested or in use, from labor, from the exercise of skill, ingenuity, or sound judgment, or from a combination of any or all of these factors. It may be defined as the gain derived from capital, from labor, or from both combined." 26 R. C. L. § 120; Tax Com. v. Putnam, 227 Mass. 522, 526, 116 N. E. 904, L. R. A. 1917F, 806; Stratton's Independence, Ltd., v. Howbert, 231 U. S. 399-415, 34 S. Ct. 136, 58 L. Ed. 285. A good definition is contained in Re Biddle Cope, 5 British Columbia, 39, 40. It is usually construed in constitutional and statutory provisions "as meaning net income as opposed to gross receipts." "Income means the balance of gain over loss, and where there is no such balance of gain there is no income which is capable of being assessed." 21 R. C. L. § 122; note to Niland v. Niland, Ann. Cas. 1915B, p. 1129; Cooley on Taxation (Income Tax) § 49.

A tax on income, as thus defined and ascertained, is not a property tax. The income or gain thus derived from capital, from property, from labor, or from both combined, because of its fluctuating and indeterminate nature, during this period and process of its making, has not yet become an investment or an increment to the permanent wealth or property of the individual who has to pay the tax, and therefore it is not a property tax. It is, however, an income tax, and the one who is the recipient of such an income may be subjected to an excise or portion cut therefrom as his modicum of the revenue necessary to meet the burdens of the government which has guaranteed to him the right to acquire and use his property, or to pursue the avocation or business from which the income is derived, and afforded him its protection for all of these rights while the income was being produced.

I am well aware that there is a conflict of authority on the question as to whether an income tax falls under the classification of a property tax or an excise tax, but I believe that the better reason, and the weight of authority, is that an income tax is an excise and not a property tax. The cases pro and con are cited in the briefs. The error in the ***733** cases holding that an income tax is a property tax says the Supreme Court of Mississippi in Hattiesburg Grocery Co. v. Robertson, supra, "results from dissociating gains derived from capital, or from labor, or from both, wholly from the activities relative thereto of the person taxed, and looking alone to the specific property which constitutes the gain so derived."

2. Having reached the conclusion that an income tax is not a property tax, but an excise tax, and that

as such it is not within our constitutional provision requiring the taxation of property to be ad valorem, equal, and uniform, we come to the next and only question of whether an income tax is prohibited by the following language of article 16, § 5, supra, to wit:

"Provided the General Assembly shall have power from time to time to tax hawkers, peddlers, ferries, exhibitions and privileges in such manner as may be deemed proper."

In a long line of decisions covering a period of more than 85 years, beginning with the case of Stevens & Woods v. State 2 Ark. 291, 35 Am. Dec. 72, on down to Standard Oil Co. v. Brodie, 153 Ark. 114, 239 S. W. 753, our court has consistently construed the above language as prohibiting the Legislature from declaring as a privilege and taxing as such for state revenue those pursuits and occupations which every one may follow as a matter of common right. Those cases have not been overruled, and therefore the above provisions of our Constitution should be interpreted to read as follows:

"The General Assembly shall have power from time to time to tax hawkers, peddlers, ferries, exhibitions and privileges in such manner as may be deemed proper, but it shall not tax for purposes of state revenue pursuits and occupations that are matters of common right."

[8] The effect of this construction of our Constitution by all of our former decisions is that the Legislature has no power to declare as a privilege and tax for revenue purposes occupations that are of common right, but it does have the power to declare as privileges and tax as such for state revenue purposes those pursuits and occupations that are not matters of common right, and to declare and tax as a privilege for state revenue any other subjects or sources of taxation that are not pursuits or occupations of common right.

Now, of the various forms and kinds of excise taxes, a tax on incomes holds its own place; it falls in its own particular and distinctive class, and must not be confounded with occupation, license, franchise, and business taxes. While an income tax is a tax laid on the income from property or occupation, it is nevertheless a special and direct tax upon the subject designated for purposes of taxation as income, whereas an occupation tax is an excise upon those engaged in a particular occupation, and although the amount of the tax may be graded in accordance with the income derived from the occupation, nevertheless a tax on the right to pursue the occupation and carry on the business is a license or occupation tax, and not an income tax. 1 Cooley on Taxation, § 49; Banger's Appeal, 109 Pa. 79-95; Central Granaries Co. v. Lancaster County, 77 Neb. 311-318, 109 N. W. 385-387; 26 R. C. L. § 116, p. 116. The right to engage in an employment, to carry on a business, or pursue an occupation or profession not in itself hurtful, or conducted in a manner injurious to the public, is a common right, which, under our Constitution as construed by all our former decisions, can neither be prohibited or hampered by laying a tax for state revenue on the occupation, employment, business, or profession. But here again let me observe that the occupation, business, profession, or employment is one thing, while the income derived therefrom is an entirely different thing. The former may not be taxed, but the latter may. Thousands of individuals in this state carry on their occupations as above defined who derive no income whatever therefrom. But, where an income is derived from any occupation, business, profession, or employment, then the Legislature may lay thereon a tax for the purpose of raising revenue to meet the expenses of government. While under our former decisions it is not within the power of the Legislature to lay a tax on occupations of common right for state revenue, yet it does not follow from these decisions, as I interpret them, that it is not within the power of the Legislature to tax the income derived therefrom for state revenue. The canon, 'expressio unius est exclusio alterius,' employed in the construction of statutes and Constitutions has no application here, for the reason that an income tax, as we have shown, is not the same thing as an occupation tax. Certainly this court has not heretofore held, and I do not believe that we should now hold, that taxes on property, and on occupations which are not matters of common right, are, together with a capitation tax, the only sources of state revenue. The effect of such a holding, it occurs to me, would be to nullify the power of the Legislature to declare as privileges and tax as such any subjects or sources of taxation not expressly designated in the Constitution, and all other privileges that are not occupations which all men may pursue as matters of common right. In other words, as I construe our Constitution, it is within the power of the Legislature to lay a property tax on all property for state revenue; the only limitation being that such tax must be ad valorem, equal, and uniform, and to select and lay taxes on all other sources or subjects of taxation for state revenue except on occupations that are matters of common right. On the latter, taxation for state revenue is prohibited by former decisions. ***734** But for these former decisions it would have been within the power of the Legislature to declare as privileges and tax as such for state revenue purposes even those occupations which are of common right. Such is the holding in Tennessee and other states under constitutional provisions similar to ours. Mabry v. Tarver, 1 Humph. 94-98; State ex rel. v. Parr, 109 Minn. 147-152, 123 N. W. 408, 134 Am. St. Rep. 759; Oliver Iron Co. v. Lord, 262 U. S. 172-179, 43 S. Ct. 526, 529 (67 L. Ed. 929). And, where such is the rule of the state courts, the Supreme Court of the United States has approved the same. In the last case it is said:

"The Legislature of the state may exercise a wide discretion in selecting the subjects of taxation, particularly as respects occupation taxes."

If we apply the rule, that the expression of one thing is the exclusion of another so as to exclude all other sources of taxation except property, capitation, and taxes on occupations that are not matters of common right, which seems to be the holding in the original opinion of the majority, then what would become of the other and numerous forms of excise taxes, such as taxes on inheritances, legacies, devises, dower, curtesy, taxes on the sale of gasoline to be used in motor-driven vehicles on the public highways, and taxes on the vehicles themselves when so driven, taxes on sales of certain commodities as cigarettes and cigars, and other commodities deemed luxuries and not necessities, taxes on franchises, etc., many of which, under the classification of privilege taxes, this court has already sanctioned as sources of state revenue. Baker v. State, 44 Ark. 134; State v. Handlin, 100 Ark. 175, 139 S. W. 1112; State v. Boney, 156 Ark. 169, 245 S. W. 315; Standard Oil Co. v. Brodie, 153 Ark. 114, 239 S. W. 753. In Baker v. State, supra, speaking of the holding in Washington v. State, 13 Ark. 752, we said:

"We do not understand this case, reading it altogether, to limit the power of legislation for state purposes to the taxation of such privileges as were technically known as such at the common law, notwithstanding an expression to that effect occurs in the opinion."

And in the case of Standard Oil Co. v. Brodie, supra, speaking still further of the holding in Washington v. State, we said:

"The restriction is not to the privileges specifically mentioned in the Constitution, nor privileges which were 'technically known as such at the common law,' but that the restriction relates merely to privileges which are matters of common right."

These, and all our former cases holding that the Legislature does not have the power to lay a tax for state revenue on privileges that are matters of common right refer to those occupations which all men have the common right to pursue. In none of the cases were we speaking of the manifold other forms and kinds of excise taxes and, as I have endeavored to show, an income tax is not the same thing as an occupation tax at all, and these cases therefore have no reference whatever to an income tax, and a conclusion based on the assumption that an income tax and an occupation tax is the same is necessarily erroneous. As I interpret our original opinion herein, we hold that, because the Legislature cannot, under the Constitution, lay a tax for state revenue on occupations of common right, it follows that it also cannot lay a tax for state revenue on incomes. This is an obvious non sequitur. It occurs to me now that to adhere to that conclusion would in effect overrule many former decisions of the court. Besides, it would be against the doctrine of all the authorities without exception, so far as I know, to the effect that the state has the power to select the sources and subjects of taxation, and to lay taxes on all those who come under the aegis of its Constitution and laws while they are in pursuit of happiness, acquiring, possessing, and enjoying the use of their property, and carrying on their varied occupations. It is a sovereign, indispensable, and inherent power reserved and possessed by the people, and is committed by them in their fundamental law to their supreme lawmaking body in order to raise revenue to meet the expense of government. It is an all-pervasive and untrammeled power, unless restricted by express constitutional limitations. Cooley on Taxation (3d Ed.) p. 9; Cooley, Const. Lim. (6th Ed.) 587.

As is well said by the Supreme Court of Ohio:

"This power would exist without a written Constitution, and the object of constitutional provisions is to regulate its exercise by such limitations and restrictions as will protect the people against unjust or arbitrary action of the governing power." Western Union Tel. Co. v. Mayer, Treasurer, etc., 28 Ohio St. 521.

Judge Cooley says:

"Everything to which the legislative power extends may be the subject of taxation, whether it be person or property or possession, franchise, or privilege, or occupation or right. Nothing but express constitutional limitation upon legislative authority can exclude anything to which the authority extends from the grasp of the taxing power, if the Legislature in its discretion shall at any time select it for revenue purposes." Cooley on Taxation, vol. 1 (3d Ed.) p. 9, and numerous cases cited by him in note.

See, also, City of Little Rock v. Prather, 46 Ark. 471-477; Fort Smith v. Scruggs, 70 Ark. 549, 69 S. W. 679, 58 L. R. A. 921, 91 Am. St. Rep. 100; Ex Parte Byles, 93 Ark. 612-616, 126 S. W. 94, 37 L. R. A. (N. S.) 774; Floyd v. Miller Lumber Co., 160 Ark. 17-25, 254 S. W. 450, 32 A. L. R. 811, where the above doctrine announced by Judge Cooley is expressly recognized.

[9][10] My conclusion of the whole matter ***735** is that there are two, and only two, limitations in our Constitution upon the power of the state to raise revenue for state purposes, namely (1) that taxes on property must be ad valorem, equal and uniform; and (2) that the Legislature cannot lay a tax for state revenue on occupations that are of common right. A tax on incomes is neither a property tax nor an occupation tax, and is not prohibited or excluded by our Constitution

Therefore, for the reason stated, I concur in the conclusion reached by Justices HART and HUMPHREYS that "it is within the discretion of the Legislature to pass a properly classified net income tax law," and such, therefore, is now the opinion and holding of the majority of this court.

McCULLOCH, C. J., and SMITH, J., dissent.

SMITH, J. (dissenting).

In my original opinion in this case, which, at the time it was handed down, was the opinion of the majority, I did not attempt to distinguish between income taxes and occupation taxes. It was stated that the act imposed both an occupation tax and an income tax, and, as the conclusion was announced that the state could not impose either, it was deemed unimportant to point out the distinction between the two.

I have never believed that an income tax is a property tax, nor do I understand that any of the Justices held to that view, unless it was entertained by Mr. Justice WOOD, and he has now announced his conviction that it is not a property tax. I concur in all that the learned Justice says on that subject in his supplementary opinion.

My original opinion was written upon the theory that the act under review had imposed both an income tax and an occupation tax, and that it was beyond the power of the Legislature to impose either.

It is true the opinions of the court which were reviewed, beginning with the case of Stevens v. State, 2 Ark. 291, dealt with attempts to tax occupations, and not incomes, but that point was not regarded as important because of the reasons given for holding that occupations could not be taxed. That reason was as applicable to taxes on income as it was to a tax on an occupation, and that reason was that the Constitution, by designating the subjects of taxation for state purposes, had excluded the subjects of taxation which were not named.

These cases speak for themselves, and I submit, without again reviewing them, that the reason given in all those cases for holding that counties and cities may tax occupations, but that the state could not do so for state purposes, was that the right had not been denied in the one case, while it had been in the other. It would appear that, if the state may tax incomes for state purposes, it may also tax occupations. No sound distinction can be drawn between the right to tax the one rather than the other. The right to tax both exists, unless the Constitution has withheld that right.

Now it has never been held that the Constitution expressly denied the state the right to tax occupations. The conclusion which has heretofore been so consistently followed that the state did not have this right resulted from the construction given the provisions of the Constitution which enumerated what the state might tax. These cases all recognized that there were two ways of imposing a constitutional restriction, viz. by express negation, or by an affirmation which implies a negation, and it was only through the application of this last method that the conclusion was reached that an occupation tax for state purposes could not be imposed.

If that rule of construction had not been invoked and applied, the court could not have held that the state did not have authority to tax occupations. No other reason was ever found or suggested for denying the state this right. All the prior cases denying the state this right are bottomed upon this proposition, as I attempted to point out in my original opinion.

If this is true, there is as much authority to levy an occupation tax as there is to levy an income tax. The Constitution does not expressly deny the right to levy either, nor does it confer the right to tax either. Now, if the enumeration of the subjects of state taxation, which does not include occupations, operates, for that reason, to exclude occupations from taxation, how can it be said that the state can tax one but cannot tax the other?

When one considers the provisions of our Constitution in regard to the subjects of taxation for state purposes and follows the reasoning by which this court, at an early date, held that occupations could not be taxed for state purposes, it appears to me that it must follow, necessarily, inevitably, that if incomes can be taxed so may occupations be, and that if occupations cannot be taxed incomes cannot be.

As I understand what is now the majority opinion, the state does not have the right to tax all incomes, but may enact a properly classified net income tax law. It appears to me that the distinction between the right, under our Constitution to tax net income and other income is as elusive as the distinction between the right to tax occupations and income. The state might tax incomes, either gross or net, and occupations as well, unless the Constitution has denied the state this right, and, if the right exists, it is the province of the Legislature to determine how it shall be exercised.

I therefore respectfully dissent from what is now the majority opinion.

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Flint v. Stone Tracy Company
Nos. 407, 409-412, 415, 420, 425, 431, 432, 442-443, 446, 456-457
Argued March 17, 18, 1910
Restored to docket for reargument May 31, 1910
Reargued January 17, 18, 19, 1911
Decided March 13, 1911.
220 U.S. 107

APPEAL FROM THE CIRCUIT COURT OF THE UNITED STATES

FOR THE DISTRICT OF VERMONT

Syllabus

The Corporation Tax, as imposed by Congress in the Tariff Act of 1909, is not a direct tax, but an excise; it does not fall within the apportionment clause of the Constitution, but is within, and complies with, the provision for uniformity throughout the United States; it is an excise on the privilege of doing business in a corporate capacity, [220 U.S. 109] and, as such, is within the power of Congress to impose; franchises of corporations are not governmental agencies of the state, and the tax is not invalid as an attempt to tax state governmental instrumentalities; not being direct taxation, but an excise, the tax is properly measured by the entire income of the parties subject to it notwithstanding a part of such income may be derived from nontaxable property; the tax does not take property without due process of law, nor is it arbitrarily unequal in its operation, either by differences in corporations or by reason of the classes exempted; the method of its enforcement is within the power of Congress, and all corporations, not specially exempted by the act itself, carrying on any business, are subject to the provisions of the law.

The substitution of a tax on incomes of corporations for a tax on inheritance in a bill for raising revenue is an amendment germane to the subject matter, and not beyond the power of the Senate to propose under § 7, Art. I, of the Constitution, providing that such bills shall originate in the House of Representatives, but that the Senate may propose or concur in amendments as in other bills. The corporation tax provision of the Tariff Act of 1909 is not unconstitutional as being a revenue measure not originating in the House of Representatives under § 7, Art. I, of the Constitution; but so *held* without holding that the journals of the House or Senate may be examined to invalidate an act which has been passed and signed by the presiding officers of both branches of Congress, approved by the President and deposited with the State Department.

A tax, such as the Corporation Tax imposed by the Tariff Act of 1909, on corporations, joint stock companies, associations organized for profit and having a capital stock represented by shares, and insurance companies, and measured by the income thereof, is not a tax on franchises of those paying it, but a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organization of the character described in the act.

Joint stock companies and associations share many benefits of corporate organization, and are properly classified with corporations in a tax measure such as the Corporation Tax. *Spreckels Sugar Refining Co. v. McClain,* 192 U.S. 397.

While the legislature cannot by a declaration change the real nature of a tax it imposes, its declaration is entitled to weight in construing the statute and determining what the actual nature of the tax is.

The Corporation Tax is not a direct tax within the enumeration provision of the Constitution, but is an impost or excise which Congress [220 U.S. 110] has power to impose under Art. I, § 8, cl. 1, of the Constitution. *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429; 158 U.S. 601, distinguished.

Indirect taxation includes a tax on business done in a corporate capacity; the difference between it and direct taxation imposed on property because of its ownership is substantial, and not merely nominal.

Excises are taxes laid upon the manufacture, sale, or consumption of commodities within the country, upon licenses to pursue certain occupations and upon corporate privileges; the requirement to pay such taxes involves the exercise of the privilege, and if business is not done in the manner described, no tax is payable.

The only limitations on the power of Congress to levy excise taxes are that they must be for the public welfare and must be uniform throughout the United States; they do not have to be apportioned.

Courts may not add any limitations on the power of Congress to impose excise taxes to that of uniformity, which was deemed sufficient by those who framed and adopted the Constitution.

The revenues of the United States must be obtained from the same territory, and the same people, and its excise taxes collected from the same activities, as are also reached by the states to support their local governments, and this fact must be considered in determining whether there are any implied limitations on the federal power to tax because of the sovereignty of the states over matters within their exclusive jurisdiction.

Enactments of Congress levying taxes are, as are other laws of the federal government acting within constitutional authority, the supreme law of the land.

Business activities such as those enumerated in the Corporation Tax Law are not beyond the excise taxing power of Congress because executed under franchises created by the states.

The power of Congress to raise revenue is essential to national existence, and cannot be impaired or limited by individuals incorporating and acting under state authority. The mere fact that business is transacted pursuant to state authority creating private corporations does not exempt it from the power of Congress to levy excise laws upon the privilege of so doing.

The exemption from federal taxation of the means and instrumentalities employed in carrying on the governmental operations of the states does not extend to state agencies and instrumentalities used for carrying on business of a private character. *South Carolina v. United States,* 199 U.S. 437. [220 U.S. 111]

The constitutional limitation of uniformity in excise taxes does not require equal application of the tax to all coming within its operation, but is limited to geographical uniformity throughout the United States. *Knowlton v. Moore,* 178 U.S. 41.

Even if the principles of the equal protection provision of the Fourteenth Amendment were applicable, there is no such arbitrary and unreasonable classification of business activities enumerated in and subject to the Corporation Tax Law as would render that law invalid. There is a sufficiently substantial difference between business as carried on in the manner specified in the act and as carried on by partnerships and individuals to justify the classification.

There are distinct advantages in carrying on business in the manner specified in the Corporation Tax Law over carrying it on by partnerships or individuals, and it is this privilege which is the subject of the tax, and not the mere buying, selling or handling of goods.

While a direct tax may be void if it reaches nontaxable property, the measure of an excise tax on privilege may be the income from all property, although part of it may be from that which is nontaxable, and the Corporation Tax is not invalid because it is levied on total income, including that derived from municipal bonds and other nontaxable property.

The measurement of the Corporation Tax by net income is not beyond the power of Congress as arbitrary and baseless. Selection of the measure and objects of taxation devolve upon Congress, and not on the courts; it is not the function of the latter to inquire into the reasonableness of the excise either as to amount or property on which it is to be imposed.

Congress has power to impose the Corporation Tax, and the act is not void as lacking in due process of law under the Fifth Amendment.

Although the power to tax is the power to destroy, *McCulloch v. Maryland,* 4 Wheat. 316, the courts cannot prevent its lawful exercise because of the fear that it may lead to disastrous results. The remedy is with the people by the election of their representatives.

Business is a comprehensive term and embraces everything about which a person can be employed, and corporations engaged in such activities as leasing and managing property, collecting rents, making investments for profit and leasing taxicabs, are engaged in business within the meaning of the Corporation Tax Law.

It is no part of the essential governmental function of a state to provide means of transportation and to supply artificial light, water and the like, and although the people of the state may derive a benefit therefrom, the public service companies carrying on such enterprises [220 U.S. 112] are private, and are subject to legitimate federal taxation, such as the Corporation Tax, the same as other corporations are.

Congress has the right to select the objects of excise taxation, and this includes the right to make exemptions; exceptions in the Corporation Tax Law of labor, agricultural, religious and certain other organizations, do not invalidate the tax or render the law unconstitutional.

Courts cannot substitute their judgment for that of the legislature; where details as to estimating the amount of an excise tax, such as the deductions for interest on bonded and other indebtedness provided by the Corporation Tax Law, are not purely arbitrary, they do not invalidate the tax.

If an excise tax operates equally on the subject matter wherever found, its geographical uniformity is not affected by the fact that it may produce unequal results in different parts of the Union.

Corporations, acting as trustees or guardians under the authority of laws of a state and compensated by the interests served and not by the state, are not agents of the state government in a sense that exempts them from the operations of federal taxation.

If it is within the power of Congress to impose the tax, it is also within its power to enact effectual means to collect the tax. *McCulloch v. Maryland,* 4 Wheat. 316, 421.

The unreasonable search and seizure provision of the Fourth Amendment does not prevent the federal government from requiring ordinary and reasonable tax returns such as those required by the Corporation Tax Law.

This Court will not pass on questions of constitutionality of a statute until they arise, and no question is now presented as to whether the provisions of the Corporation Tax Law offend the self-incrimination provisions of the Fifth Amendment or whether the penalties for noncompliance are so high as to violate the Constitution; the penalty provisions of the act are separable, and their constitutionality can be determined if a proper case arises.

No case is presented on this record involving the question of lack of power to tax foreign corporations doing local business in a state, or whether, if the tax on foreign corporation is unconstitutional, it would invalidate the tax on domestic corporations as working an inequality against the latter; nor is any case presented involving the invalidity of the act as a tax on exports.

The facts, which involve the constitutional validity of the Corporation Tax Law, being § 38 of the [220 U.S. 113] Payne-Aldrich Tariff Act of August 5, 1909, are stated in the opinion. [220 U.S. 142]

DAY, J., lead opinion

MR. JUSTICE DAY delivered the opinion of the Court.

These cases involve the constitutional validity of § 38 of the Act of Congress approved August 5, 1909, known as "the corporation tax" law. 36 Stat., c. 6, 11, 112-117.

It is contended in the first place that this section of the act is unconstitutional, because it is a revenue measure, and originated in the Senate in violation of § 7 of Article I of the Constitution, providing that "all bills for raising revenue shall originate in the House of Representatives, but the Senate may propose or concur with the amendments, as on other bills." The history of the act [220 U.S. 143] is contained in the government's brief, and is accepted as correct, no objection being made to its accuracy.

This statement shows that the tariff bill of which the section under consideration is a part originated in the House of Representatives, and was there a general bill for the collection of revenue. As originally introduced, it contained a plan of inheritance taxation. In the Senate, the proposed tax was removed from the bill, and the corporation tax, in a measure, substituted therefor. The bill having properly originated in the House, we perceive no reason in the constitutional provision relied upon why it may not be amended in the Senate in the manner which it was in this case. The amendment was germane to the subject matter of the bill, and not beyond the power of the Senate to propose. In thus deciding, we do not wish to be regarded as holding that the journals of the House and Senate may be examined to invalidate an act which has been passed and signed by the presiding officers of the House and Senate, and approved by the President, and duly deposited with the State Department. *Marshall Field & Co. v. Clark,* 143 U.S. 649; *Harwood v. Wentworth,* 162 U.S. 547; *Twin City Bank v. Nebeker,* 167 U.S. 196.

In order to have in mind some of the more salient features of the statute, with a view to its interpretation, a part of the first paragraph is here set out, as follows:

> 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 [220 U.S. 144] to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company equivalent to one percentum 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.

A reading of this portion of the statute shows the purpose and design of Congress in its enactment and the subject matter of its operation. It is at once apparent that its terms embrace corporations and joint stock companies or associations which are organized for profit, and have a capital stock represented by shares. Such joint stock companies, while differing somewhat from corporations, have many of their attributes and enjoy many of their privileges. To these are added insurance companies, and they, as corporations, joint stock companies, or associations, must be such as are 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 and the District of Columbia. Each and all of these, the statute declares, shall be subject to pay annually a special excise tax with respect to the carrying on and doing business by such corporation, joint stock company or association, or insurance company. The tax is to be equivalent to one percent of the entire net [220 U.S. 145] income over and above $5,000 received by such corporation or company *from all sources* during the year, excluding, however, amounts received by them as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed by the statute. Similar companies 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 the District of Columbia, are required to pay the tax upon the net income over and above $5,000 received by them from business transacted and capital invested within the United States, the territories, Alaska, and the District of Columbia, during each year, with the like exclusion as to amounts received by them as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed.

While the mere declaration contained in a statute that it shall be regarded as a tax of a particular character does not make it such if it is apparent that it cannot be so designated consistently with the meaning and effect of the act, nevertheless the declaration of the lawmaking power is entitled to much weight, and in this statute, the intention is expressly declared to impose a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company, or association, or company. It is therefore apparent, giving all the words of the statute effect, that the tax is imposed not upon the franchises of the corporation, irrespective of their use in business, nor upon the property of the corporation, but upon the doing of corporate or insurance business, and with respect to the carrying on thereof, in a sum equivalent to one percentum upon the entire net income over and above $5,000 received from all sources during the year; that is, when imposed in this manner it is a tax upon the doing of business, with the advantages which inhere in the peculiarities [220 U.S. 146] of corporate or joint stock organization of the character described. As the latter organizations share many benefits of corporate organization, it may be described generally as a tax upon the doing of business in a corporate capacity. In the case of the insurance companies, the tax is imposed upon the transaction of such business by companies organized under the laws of the United States or any state or territory, as heretofore stated.

This tax, it is expressly stated, is to be equivalent to one percentum of the entire net income over and above $5,000 received from *all sources* during the year -- this is the measure of the tax explicitly adopted by the statute. The income is not limited to such as is received from property used in the business, strictly speaking, but is expressly declared to be upon the entire net income above $5,000 from all sources, excluding the amounts received as dividends on stock in other corporations, joint stock companies or associations, or insurance companies also subject to the tax. In other words, the tax is imposed upon the doing of business of the character described, and the measure of the tax is to be income, with the deduction stated, received not only from property used in business, but from every source. This view of the measure of the tax is strengthened when we note that as to organizations under the laws of foreign countries, the amount of net income over and above $5,000 includes that received from business transacted and capital invested in the United States, the territories, Alaska, and the District of Columbia.

It is further strengthened when the subsequent sections are considered as to deductions in ascertaining net income and requiring returns from those subject to the act. Under the second paragraph, the net income is to be ascertained by certain deductions from the gross amount of income received within the year "from all sources;" and the return to be made to the collector of internal revenue [220 U.S. 147] under the third section is required to show the gross amount of the income, received during the year "from all sources." The evident purpose is to secure a return of the entire income, with certain allowances and deductions which do not suggest a restriction to income derived from property actively engaged in the business. This interpretation of the act, as resting upon the doing of business, is sustained by the reasoning in *Spreckels Sugar Ref. Co. v. McClain,* 192 U.S. 397, in which a special tax measured by the gross receipts of the business of refining oil and sugar was sustained as an excise in respect to the carrying on or doing of such business.

Having thus interpreted the statute in conformity, as we believe, with the intention of Congress in passing it, we proceed to consider whether, as thus construed, the statute is constitutional.

It is contended that it is not; certainly so far as the tax is measured by the income of bonds nontaxable under federal statutes, and municipal and state bonds beyond the federal power of taxation. And so of real and personal estates, because as to such estates the tax is direct, and required to be apportioned according to population among the states. It is insisted that such must be the holding unless this Court is prepared to reverse the income tax cases decided under the Act of 1894. *Pollock v. Farmers' Loan & Trust Co.,* 157 U.S. 429, *s.c.* 158 U.S. 601.

The applicable provisions of the Constitution of the United States in this connection are found in Article I, § 8, clause 1, and in Article I, § 2, clause 3, and Article I, § 9, clause 4. They are respectively:

> The Congress shall have power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States. [220 U.S. 148]

> Representatives and direct taxes shall be apportioned among the several states which may be included within this Union, according to their respective numbers.
>
> No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.

It was under the latter requirement as to apportionment of direct taxes according to population that this Court in the *Pollock* case held the statute of 1894 to be unconstitutional. Upon the rehearing of the case, Mr. Chief Justice Fuller, who spoke for the Court, summarizing the effect of the decision, said:

> We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such.

158 U.S. 635.

And as to excise taxes, the Chief Justice said:

> We do not mean to say that an act laying by apportionment a direct tax on all real estate and personal property, or the income thereof, might not also lay excise taxes on business, privileges, employments, and vocations.

P. 637.

The *Pollock* case was before this Court in *Knowlton v. Moore,* 178 U.S. 41. In that case, this Court sustained an excise tax upon the transmission of property by inheritance. It was contended there, as here, that the case was ruled by the *Pollock* case, and of that case this Court, speaking by the present CHIEF JUSTICE, said:

> The issue presented in the *Pollock* case was whether an income tax was direct within the meaning of the Constitution. The contentions which the case involved were thus presented. On the one hand, it was argued that only [220 U.S. 149] capitation taxes and taxes on land as such were direct, within that previous adjudications had construed as a matter of first impression, and that previous adjudications had construed the Constitution as having that import. On the other hand, it was asserted that, in principle, direct taxes, in the constitutional sense, embraced not only taxes on land and capitation taxes, but all burdens laid on real or personal property because of its ownership, which were equivalent to a direct tax on such property, and it was affirmed that the previous adjudications of this Court had settled nothing to the contrary.
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> * * * *
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> Undoubtedly, in the course of the opinion in the *Pollock* case, it was said that, if a tax was direct within the constitutional sense, the mere erroneous qualification of it as an excise or duty would not take it out of the constitutional requirement as to apportionment. But this language related to the subject matter under consideration, and was but a statement that a tax which was, in itself, direct, *because imposed upon property solely by reason of its ownership,* could not be changed by affixing to it the qualification of excise or duty. Here we are asked to decide that a tax is a direct tax on property which has at all times been considered as the antithesis of such a tax – that is, that it has ever been treated as a duty or excise, because of the particular occasion which gives rise to its levy.
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> * * * *
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> Considering that the constitutional rule of apportionment had its origin in the purpose to prevent taxes on persons *solely because of their general ownership of property* from being levied by any other rule than that of apportionment, two things were decided by the court: first, that no sound distinction existed between a tax levied on a person solely because of his general ownership of real property, and the same tax imposed solely because of his general ownership of personal property; secondly, that the [220 U.S. 150] tax on the income derived from such property, real or personal, was the legal equivalent of a direct tax on the property from which said income was derived, and hence must be apportioned. These conclusions, however, lend no support to the contention that it was decided that duties, imposts, and excises, which are not the essential equivalent of a tax on property generally, real or personal, solely because of its ownership, must be converted into direct taxes, because it is conceived that it would be demonstrated by a close analysis that they could not be shifted from the person upon whom they first fall.

The same view was taken of the *Pollock* case in the subsequent case of *Spreckels Sugar Ref. Co. v. McClain, supra.*

The act now under consideration does not impose direct taxation upon property solely because of its ownership, but the tax is within the class which Congress is authorized to lay and collect under Article I, § 8, clause 1 of the Constitution, and described generally as taxes, duties, imposts, and excises, upon which the limitation is that they shall be uniform throughout the United States.

Within the category of indirect taxation, as we shall have further occasion to show, is embraced a tax upon business done in a corporate capacity, which is the subject matter of the tax imposed in the act under consideration. The *Pollock* case construed the tax there levied as direct, because it was imposed upon property simply because of its ownership. In the present case, the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax, measured by the standard prescribed. The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way.

It is unnecessary to enter upon an extended consideration of the technical meaning of the term "excise." It has [220 U.S. 151] been the subject matter of considerable discussion -- the terms duties, imposts, and excises are generally treated as embracing the indirect forms of taxation contemplated by the Constitution. As Mr. Chief Justice Fuller said in the *Pollock* case, *supra:*

> Although there have been from time to time intimations that there might be some tax which was not a direct tax nor included under the words "duties, imposts, and excises," such a tax for more than one hundred years of national existence has as yet remained undiscovered, notwithstanding the stress of particular circumstances has invited thorough investigation into sources of revenue.

And in the same connection the Chief Justice, delivering the opinion of the court in *Thomas v. United States,* 192 U.S. 363, in speaking of the words "duties," "imposts," and "excises," said:

> We think that they were used comprehensively, to cover customs and excise duties imposed on importation, consumption, manufacture, and sale of certain commodities, privileges, particular business transactions, vocations, occupations, and the like.

Duties and imposts are terms commonly applied to levies made by governments on the importation or exportation of commodities. Excises are

> taxes laid upon the manufacture, sale, or consumption of commodities within the country, upon licenses to pursue certain occupations, and upon corporate privileges.

Cooley, Const.Lim., 7th ed., 680.

The tax under consideration, as we have construed the statute, may be described as an excise upon the particular privilege of doing business in a corporate capacity, *i.e.,* with the advantages which arise from corporate or *quasi* corporate organization; or, when applied to insurance companies, for doing the business of such companies. As was said in the *Thomas* case, 192 U.S. 363, *supra,* the requirement to pay such taxes involves the exercise of [220 U.S. 152] privileges, and the element of absolute and unavoidable demand is lacking. If business is not done in the manner described in the statute, no tax is payable.

If we are correct in holding that this is an excise tax, there is nothing in the Constitution requiring such taxes to be apportioned according to population. *Pacific Ins. Co. v. Soule,* 7 Wall. 433; *Springer v. United States,* 102 U.S. 586; *Spreckels Sugar Ref. Co. v. McClain,* 192 U.S. 397.

It is next contended that the attempted taxation is void because it levies a tax upon the exclusive right of a state to grant corporate franchises, because it taxes franchises which are the creation of the state in its sovereign right and authority. This proposition is rested upon the implied limitation upon the powers of national and state governments to take action which encroaches upon or cripples the exercise of the exclusive power of sovereignty in the other. It has been held in a number of cases that the state cannot tax franchises created by the United States or the agencies or corporations which are created for the purpose of carrying out governmental functions of the United States. *M'Culloch v. Maryland,* 4 Wheat. 316; *Osborn v. Bank of United States,* 9 Wheat. 738; *Railroad Co. v. Peniston,* 18 Wall. 5; *California v. Central Pac. R. Co.,* 127 U.S. 1.

An examination of these cases will show that in each case where the tax was held invalid, the decision rested upon the proposition that the corporation was created to carry into effect powers conferred upon the federal government in its sovereign capacity, and the attempted taxation was an interference with the effectual exercise of such powers.

In *Osborn v. Bank of United States, supra,* a leading case upon the subject, whilst it was held that the bank of the United States was not a private corporation, but a public one, created for national purposes, and therefore beyond the [220 U.S. 153] taxing power of the state, Chief Justice Marshall, in delivering the opinion of the Court, conceded that, if the corporation had been originated for the management of an individual concern, with private trade and profit for its great end and principal object, it might be taxed by the state. Said the Chief Justice:

> If these premises [that the corporation was one of private character] were true, the conclusion drawn from them would be inevitable. This mere private corporation, engaged in its own business, with its own views, would certainly be subject to the taxing power of the state, as any individual would be, and the casual circumstance of its being employed by the government in the transaction of its fiscal affairs would no more exempt its private business from the operation of that power than it would exempt the private business of any individual employed in the same manner.

The inquiry in this connection is how far do the implied limitations upon the taxing power of the United States over objects which would otherwise be legitimate subjects of federal taxation withdraw them from the reach of the federal government in raising revenue because they are pursued under franchises which are the creation of the states?

In approaching this subject, we must remember that enactments levying taxes, as other laws of the federal government when acting within constitutional authority, are the supreme law of the land. The Constitution contains only two limitations on the right of Congress to levy excise taxes: they must be levied for the public welfare, and are required to be uniform throughout the United States. As Mr. Chief Justice Chase said, speaking for the Court in *License Tax Cases,* 5 Wall. 462, 471:

> Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity. Thus, limited, and thus only, it reaches every [220 U.S. 154] subject and may be exercised at discretion.

The limitations to which the Chief Justice refers were the only ones imposed in the Constitution upon the taxing power.

In *McCray v. United States,* 195 U.S. 27, this Court sustained a federal tax on oleomargarine, artificially colored, and held that, while the Fifth and Tenth Amendments qualify, so far as applicable, all the provisions of the Constitution, nothing in those amendments operates to take away the power to tax conferred by the Constitution on the Congress. In that case, it was contended that the subject taxed was within the exclusive domain of the states, and that the real purpose of Congress was not to raise revenue, but to tax out of existence a substance not harmful of itself and one which might be lawfully manufactured and sold; but the only constitutional limitation which this Court conceded, in addition to the requirement of uniformity, and that, for the sake of argument only so far as concerned the case then under consideration, was that Congress is restrained from arbitrary impositions or from exceeding its power in seeking to effect unwarranted ends. The limitation of uniformity was deemed sufficient by those who framed and adopted the Constitution. The courts may not add others. *Patton v. Brady,* 184 U.S. 608, 622. *And see United States v. Singer,* 15 Wall. 111, 121; *Nicol v. Ames,* 173 U.S. 509, 515.

We must therefore enter upon the inquiry as to implied limitations upon the exercise of the federal authority to tax because of the sovereignty of the states over matters within their exclusive jurisdiction, having in view the nature and extent of the power specifically conferred upon Congress by the Constitution of the United States. We must remember too that the revenues of the United States must be obtained in the same territory, from the same people, and excise taxes must be collected from the same activities, as are also reached by the states in order to support their local government. [220 U.S. 155]

While the tax in this case, as we have construed the statute, is imposed upon the exercise of the privilege of doing business in a corporate capacity, as such business is done under authority of state franchises, it becomes necessary to consider in this connection the right of the federal government to tax the activities of private corporations which arise from the exercise of franchises granted by the state in creating and conferring powers upon such corporations. We think it is the result of the cases heretofore decided in this Court that such business activities, though exercised because of state-created franchises, are not beyond the taxing power of the United States. Taxes upon rights exercised under grants of state franchises were sustained by this Court in *Railroad Co. v. Collector,* 100 U.S. 595; *United States v. Erie R. Co.,* 106 U.S. 327; *Spreckels Sugar Refining Co. v. McClain,* 192 U.S. 397.

It is true that in those cases the question does not seem to have been directly made, but, in sustaining such taxation, the right of the federal government to reach such agencies was necessarily involved. The question was raised and decided in the case of *Veazie Bank v. Fenno,* 8 Wall. 533. In that well known case, a tax upon the notes of a state bank issued for circulation was sustained. Mr. Chief Justice Chase, in the course of the opinion, said:

> Is it, then, a tax on a franchise granted by a state, which Congress, upon any principle exempting the reserved powers of the states from impairment by taxation, must be held to have no authority to lay and collect?
>
> We do not say that there may not be such a tax. It may be admitted that the reserved rights of the states, such as the right to pass laws, to give effect to laws through executive action, to administer justice through the courts, and to employ all necessary agencies for legitimate purposes of state government, are not proper subjects of the taxing power of Congress. But it cannot be admitted that [220 U.S. 156] franchises granted by a state are necessarily exempt from taxation, for franchises are property, often very valuable and productive property, and when not conferred for the purpose of giving effect to some reserved power of a state, seem to be as properly objects of taxation as any other property.
>
> But, in the case before us, the object of taxation is not the franchise of the bank, but property created, or contracts made and issued under the franchise, or power to issue bank bills. A railroad company, in the exercise of its corporate franchises, issues freight receipts, bills of lading, and passenger tickets, and it cannot be doubted that the organization of railroads is quite as important to the state as the organization of banks. But it will hardly be questioned that these contracts of the company are objects of taxation within the powers of Congress, and not exempted by any relation to the state which granted the charter of the railroad. And it seems difficult to distinguish the taxation of notes issued for circulation from the taxation of these railroad contracts. Both descriptions of contracts are means of profit to the corporations which issue them, and both, as we think, may properly be made contributory to the public revenue.

Pp. 547-548.

It is true that the decision in the *Veazie Bank* case was also placed, in a measure, upon the authority of the United States to control the circulating medium of the country, but the force of the reasoning which we have quoted has not been denied or departed from.

In *Thomas v. United States,* 192 U.S. 363, a federal tax on the transfer of corporate shares in state corporations was upheld as a tax upon business transacted in the exercise of privileges afforded by the state laws in respect to corporations.

In *Nicol v. Ames,* 173 U.S. 509, a federal tax was sustained upon the enjoyment of privileges afforded by a board of trade incorporated by the State of Illinois. [220 U.S. 157]

When the Constitution was framed, the right to lay excise taxes was broadly conferred upon the Congress. At that time, very few corporations existed. If the mere fact of state incorporation, extending now to nearly all branches of trade and industry, could withdraw the legitimate objects of federal taxation from the exercise of the power conferred, the result would be to exclude the national government from many objects upon which indirect taxes could be constitutionally imposed. Let it be supposed that a group of individuals, as partners, were carrying on a business upon which Congress concluded to lay an excise tax. If it be true that the forming of a state corporation would defeat this purpose, by taking the necessary steps required by the state law to create a corporation and carrying on the business under rights granted by a state statute, the federal tax would become invalid and that source of national revenue be destroyed, except as to the business in the hands of individuals or partnerships. It cannot be supposed that it was intended that it should be within the power of individuals acting under state authority to thus impair and limit the exertion of authority which may be essential to national existence.

In this connection, *South Carolina v. United States,* 199 U.S. 437, is important. In that case, it was held that the agents of the state government, carrying on the business of selling liquor under state authority, were liable to pay the internal revenue tax imposed by the federal government. In the opinion, previous cases in this Court were reviewed, and the rule to be deduced therefrom stated to be that the exemption of state agencies and instrumentalities from national taxation was limited to those of a strictly governmental character, and did not extend to those used by the state in carrying on business of a private character. 199 U.S. 461.

The cases unite in exempting from federal taxation the means and instrumentalities employed in carrying on the [220 U.S. 158] governmental operations of the state. The exercise of such rights as the establishment of a judiciary, the employment of officers to administer and execute the laws, and similar governmental functions, cannot be taxed by the federal government. *The Collector v. Day,* 11 Wall. 113; *United States v. Railroad Co.,* 17 Wall. 322; *Ambrosini v. United States,* 187 U.S. 1.

But this limitation has never been extended to the exclusion of the activities of a merely private business from the federal taxing power, although the power to exercise them is derived from an act of incorporation by one of the states. We therefore reach the conclusion that the mere fact that the business taxed is done in pursuance of authority granted by a state in the creation of private corporations does not exempt it from the exercise of federal authority to levy excise taxes upon such privileges.

But, it is insisted, this taxation is so unequal and arbitrary in the fact that it taxes a business when carried on by a corporation, and exempts a similar business when carried on by a partnership or private individual, as to place it beyond the authority conferred upon Congress. As we have seen, the only limitation upon the authority conferred is uniformity in laying the tax, and uniformity does not require the equal application of the tax to all persons or corporations who may come within its operation, but is limited to geographical uniformity throughout the United States. This subject was fully discussed and set at rest in *Knowlton v. Moore,* 178 U.S. 41, and we can add nothing to the discussion contained in that case.

In levying excise taxes, the most ample authority has been recognized from the beginning to select some and omit other possible subjects of taxation, to select one calling and omit another, to tax one class of property and to forbear to tax another. For examples of such taxation see [220 U.S. 159] cases in the margin, decided in this Court, upholding the power.{1}

Many instances might be given where this Court has sustained the right of a state to select subjects of taxation, although as to them the Fourteenth Amendment imposes a limitation upon state legislatures, requiring that no person [220 U.S. 160] shall be denied the equal protection of the laws. *See* some of them noted in the margin.{2}

In *Bell's Gap R. Co. v. Pennsylvania,* 134 U.S. 232, dealing with the Fourteenth Amendment, which in this respect imposes limitations only on state authority, this Court said:

> The provision in the Fourteenth Amendment, that no state shall deny to any person within its jurisdiction the equal protection of the laws, was not intended to prevent a state from adjusting its system of taxation in all proper and reasonable ways. It may, if it chooses, exempt certain classes of property from any taxation at all, such as churches, libraries, and the property of charitable institutions. It may impose different specific taxes upon different trades and professions, and may vary the rates of excise upon various products; it may tax real estate and personal property in a different manner; it may tax visible property only, and not tax securities for payment of money; it may allow deductions for indebtedness, or not [220 U.S. 161] allow them. All such regulations, and those of like character, so long as they proceed within reasonable limits and general usage, are within the discretion of the state legislature, or the people of the state in framing their Constitution.

It is insisted in some of the briefs assailing the validity of this tax that these cases have been modified by *Southern R. Co. v. Greene,* 216 U.S. 400. In that case, a corporation organized in a state other than Alabama came into that state in compliance with its laws, paid the license tax and property tax imposed upon other corporations doing business in the state, and acquired, under direct sanction of the laws of the state, a large amount of property therein, and when it was attempted to subject it to a further tax, on the ground that it was for the privilege of doing business as a foreign corporation, when the same tax was not imposed upon state corporations doing precisely the same business, in the same way, it was held that the attempted taxation was merely arbitrary classification, and void under the Fourteenth Amendment. In that case, the foreign corporation was doing business under the sanction of the state laws no less than the local corporation; it had acquired its property under sanction of those laws; it had paid all direct and indirect taxes levied against it, and there was no practical distinction between it and a state corporation doing the same business in the same way.

In the case at bar, we have already discussed the limitations which the Constitution imposes upon the right to levy excise taxes, and it could not be said, even if the principles of the Fourteenth Amendment were applicable to the present case, that there is no substantial difference between the carrying on of business by the corporations taxed, and the same business when conducted by a private firm or individual. The thing taxed is not the mere dealing in merchandise, in which the actual transactions may be the same, whether conducted by individuals or corporations, [220

U.S. 162] but the tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed, and which are not enjoyed by private firms or individuals. These advantages are obvious, and have led to the formation of such companies in nearly all branches of trade. The continuity of the business, without interruption by death or dissolution, the transfer of property interests by the disposition of shares of stock, the advantages of business controlled and managed by corporate directors, the general absence of individual liability, these and other things inhere in the advantages of business thus conducted, which do not exist when the same business is conducted by private individuals or partnerships. It is this distinctive privilege which is the subject of taxation, not the mere buying or selling or handling of goods, which may be the same, whether done by corporations or individuals.

It is further contended that some of the corporations, notably insurance companies, have large investments in municipal bonds and other nontaxable securities, and in real estate and personal property not used in the business; that therefore the selection of the measure of the income from all sources is void, because it reaches property which is not the subject of taxation, upon the authority of the *Pollock* case, *supra.* But this argument confuses the measure of the tax upon the privilege with direct taxation of the state or thing taxed. In the *Pollock* case, as we have seen, the tax was held unconstitutional because it was in effect a direct tax on the property solely because of its ownership.

Nor does the adoption of this measure of the amount of the tax do violence to the rule laid down in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas,* 210 U.S. 217, nor *Western Union Telegraph Co. v. Kansas,* 216 U.S. 1. In the *Galveston* case, it was held that a tax imposed by the State of Texas, equal to one percent upon the gross [220 U.S. 163] receipts "from every source whatever" of lines of railroad lying wholly within the state, was invalid as an attempt to tax gross receipts derived from the carriage of passengers and freight in interstate commerce, which in some instances was much the larger part of the gross receipts taxed. This Court held that this act was an attempt to burden commerce among the states, and the fact that it was declared to be "equal to" one percent made no difference, as it was merely an effort to reach gross receipts by a tax not even disguised as an occupation tax, and in nowise helped by the words "equal to." In other words, the tax was held void, as its substance and manifest intent was to tax interstate commerce as such.

In the *Western Union Telegraph* cases, the state undertook to levy a graded charter fee upon the entire capital stock of one hundred millions of dollars of the Western Union Telegraph Company, a foreign corporation, and engaged in commerce among the states, as a condition of doing local business within the State of Kansas. This Court held, looking through forms and reaching the substance of the thing, that the tax thus imposed was in reality a tax upon the right to do interstate commerce within the state, and an undertaking to tax property beyond the limits of the state; that whatever the declared purpose, when reasonably interpreted, the necessary operation and effect of the act in question was to burden interstate commerce and to tax property beyond the jurisdiction of the state, and it was therefore invalid.

There is nothing in these cases contrary, as we shall have occasion to see, to the former rulings of this Court which hold that, where a tax is lawfully imposed upon the exercise of privileges within the taxing power of the state or nation, the measure of such tax may be the income from the property of the corporation, although a part of such income is derived from property, in itself, nontaxable. The distinction lies between the attempt to tax the property [220 U.S. 164] as such and to measure a legitimate tax upon the privileges involved in the use of such property.

In *Home Ins. Co. v. New York,* 134 U.S. 594, a tax was sustained upon the right or privilege of the Home Insurance Company to be a corporation, and to do business within the state in a corporate capacity, the tax being measured by the extent of the dividends of the corporation in the current year upon the capital stock. Although a very large amount, nearly two of three millions of capital stock, was invested in bonds of the United States, expressly exempted from taxation by a statute of the United States, the tax was sustained as a mode of measurement of a privilege tax which it was within the lawful authority of the state to impose. Mr. Justice Field, who delivered the opinion of the Court, reviewed the previous cases in this Court, holding that the state could not tax or burden the operation of the Constitution and of laws enacted by the Congress to carry into execution the powers vested in the general government. Yielding full assent to those cases, Mr. Justice Field said of the tax then under consideration:

> It is not a tax in terms upon the capital stock of the company, nor upon any bonds of the United States composing a part of that stock. The statute designates it a tax upon the "corporate franchise or business" of the company, and reference is only made to its capital stock and

> dividends for the purpose of determining the amount of the tax to be exacted each year.

In that case, in the course of the opinion, previous cases of this Court were cited, with approval. *Society for Savings v. Coite,* 6 Wall. 594; *Provident Institution v. Massachusetts,* 6 Wall. 611.

In the *Coite* case, a privilege tax upon the total amount of deposits in a savings bank was sustained, although $500,000 of the deposits had been invested in securities of the United States, and declared by act of Congress to be exempt from taxation by state authority. In that case, the Court said:

> Nothing can be more certain in legal [220 U.S. 165] decision than that the privileges and franchises of a private corporation, and all trades and avocations by which the citizens acquire a livelihood, may be taxed by a state for the support of the state government. Authority to that effect resides in the state independent of the federal government, and is wholly unaffected by the fact that the corporation or individual has or has not made investment in federal securities.

In *Provident Institution v. Massachusetts, supra,* a like tax was sustained.

It is therefore well settled by the decisions of this Court that, when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege, it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is nontaxable. Applying that doctrine to this case, the measure of taxation being the income of the corporation from all sources, as that is but the measure of a privilege tax within the lawful authority of Congress to impose, it is no valid objection that this measure includes, in part at least, property which, as such, could not be directly taxed. *See,* in this connection, *Maine v. Grand Trunk Ry. Co.,* 142 U.S. 217, as interpreted in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas,* 210 U.S. 217, 226.

It is contended that measurement of the tax by the net income of the corporation or company received by it from all sources is not only unequal, but so arbitrary and baseless as to fall outside of the authority of the taxing power. But is this so? Conceding the power of Congress to tax the business activities of private corporations, including, as in this case, the privilege of carrying on business in a corporate capacity, the tax must be measured by some standard, and none can be chosen which will operate with absolute justice and equality upon all corporations. Some corporations do a large business upon a small amount of capital; others with a small business may have a large [220 U.S. 166] capital. A tax upon the amount of business done might operate as unequally as a measure of excise as it is alleged the measure of income from all sources does. Nor can it be justly said that investments have no real relation to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige.

It is true that in the *Spreckels* case, 192 U.S., *supra,* the excise tax, for the privilege of doing business, was based upon the business assets in use by the company, but this was because of the express terms of the statute which thus limited the measure of the excise. The statute now under consideration bears internal evidence that its draftsman had in mind language used in the opinion in the *Spreckels* case, and the measure of taxation, the income from all sources, was doubtless inserted to prevent the limitation of the measurement of the tax to the income from business assets alone. There is no rule which permits a court to say that the measure of a tax for the privilege of doing business, where income from property is the basis, must be limited to that derived from property which may be strictly said to be actively used in the business. Departures from that rule, sustained in this Court, are not wanting. In *United States v. Singer,* 15 Wall. 111, an excise tax was sustained upon the liquor business, which was fixed by the payment of an amount not less than 80 percent of the total capacity of the distillery. Whether such capacity was used in the business was a matter of indifference, and this Court said of such a measure:

> Everyone is advised in advance of the amount he will be required to pay if he enters into the business of distilling spirits, and every distiller must know the producing [220 U.S. 167] capacity of his distillery. If he fail under these circumstances to produce the amount for which, by the law, he will, in any event, be taxed if he undertakes to distill at all, he is not entitled to much consideration.

In *Society for Savings v. Coite,* 6 Wall., *supra,* and *Provident Institution v. Massachusetts,* 6 Wall., *supra,* as we have seen, the amount of excise was measured by the amount of bank deposits. It made no difference that the deposits were not used actively in the business.

In *Hamilton Company v. Massachusetts,* 6 Wall. 632, the tax was measured by the excess of the market value of the corporation's capital stock above the value of its real estate and machinery, and in this connection *see Home Ins. Co. v. New York,* 134 U.S. *supra,* where the excise was computed upon the entire capital stock, measured by the extent of the dividends thereon.

We must not forget that the right to select the measure and objects of taxation devolves upon the Congress, and not upon the courts, and such selections are valid unless constitutional limitations are overstepped.

> It is no part of the function of a court to inquire into the reasonableness of the excise, either as respects the amount or the property upon which it is imposed.

Patton v. Brady, 184 U.S. 608; *McCray v. United States,* 195 U.S. 27, 58, and previous cases in this Court there cited.

Nor is that line of cases applicable, such as *Brown v. Maryland,* 12 Wheat. 419, holding that a tax on the sales of an importer is a tax on the import, and *Cook v. Pennsylvania,* 97 U.S. 566, holding a tax on auctioneers' sales of goods in original packages a tax on imports. In these cases, the tax was held invalid, as the state thereby taxed subjects of taxation within the exclusive power of Congress.

What we have said as to the power of Congress to lay this excise tax disposes of the contention that the act is void, as lacking in due process of law. [220 U.S. 168]

It is urged that this power can be so exercised by Congress as to practically destroy the right of the states to create corporations, and for that reason it ought not to be sustained, and reference is made to the declaration of Chief Justice Marshall in *M'Culloch v. Maryland* that the power to tax involves to power to destroy. This argument has not been infrequently addressed to this Court with respect to the exercise of the powers of Congress. Of such contention, this Court said in *Knowlton v. Moore, supra:*

> This principle is pertinent only when there is no power to tax a particular subject, and has no relation to a case where such right exists. In other words, the power to destroy, which may be the consequence of taxation, is a reason why the right to tax should be confined to subjects which may be lawfully embraced therein, even although it happens that in some particular instance no great harm may be caused by the exercise of the taxing authority as to a subject which is beyond its scope. But this reasoning has no application to a lawful tax, for if it had, there would be an end of all taxation; that is to say, if a lawful tax can be defeated because the power which is manifested by its imposition may, when further exercised, be destructive, it would follow that every lawful tax would become unlawful, and therefore no taxation whatever could be levied.

In *Veazie Bank v. Fenno,* 8 Wall. 533, *supra,* speaking for the Court, the Chief Justice said:

> It is insisted, however, that the tax in the case before us is excessive, and so excessive as to indicate a purpose on the part of Congress to destroy the franchise of the bank, and is therefore beyond the constitutional power of Congress.
>
> The first answer to this is that the judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons, [220 U.S. 169] but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected. So, if a particular tax bears heavily upon a corporation, or a class of corporations, it cannot, for that reason only, be pronounced contrary to the Constitution.

To the same effect: *McCray v. United States,* 195 U.S. 27. In the latter case, it was said:

> . . . no instance is afforded from the foundation of the government where an act which was within a power conferred was declared to be repugnant to the Constitution because it appeared to the judicial mind that the particular exertion of constitutional power was either unwise or unjust.

And in the same case, this Court said, after reviewing the previous cases in this Court:

> Since, as pointed out in all the decisions referred to, the taxing power conferred by the Constitution knows no limits except those expressly stated in that instrument, it must follow, if a tax be within the lawful power, the exertion of that power may not be judicially restrained because of the results to arise from its exercise.

The argument at last, comes to this: that, because of possible results, a power lawfully exercised may work disastrously, therefore the courts must interfere to prevent its exercise, because of the consequences feared. No such authority has ever been invested in any court. The remedy for such wrongs, if such in fact exist, is in the ability of the people to choose their own representatives, and not in the exertion of unwarranted powers by courts of justice.

It is especially objected that certain of the corporations whose stockholders challenge the validity of the tax are so-called real estate companies, whose business is principally the holding and management of real estate. These cases are No. 415, *Cedar Street Company v. Park Realty Company;* No. 431, *Percy H. Brundage v. Broadway Realty* [220 U.S. 170] *Company;* No. 443, *Phillips v. Fifty Associates et al.;* No. 446, *Mitchell v. Clark Iron Company;* No. 412, *William H. Miner v. Corn Exchange Bank et al.,* and No. 457, *Cook et al. v. Boston Wharf Company.*

In No. 412, *Miner v. Corn Exchange Bank et al.,* the bank occupies a building in part and rents a large part to tenants.

Of the realty companies, the Park Realty Company was organized to

> work, develop, sell, convey, mortgage, or otherwise dispose of real estate; to lease, exchange, hire, or otherwise acquire property; to erect, alter, or improve buildings; to conduct, operate, manage, or lease hotels, apartment houses, etc.; to make and carry out contracts in the manner specified concerning buildings . . . and generally to deal in, sell, lease, exchange, or otherwise deal with lands, buildings, and other property, real or personal,

etc.

At the time the bill was filed, the business of the company related to the Hotel Leonori, and the bill averred that it was engaged in no other business except the management and leasing of that hotel.

The Broadway Realty Company was formed for the purpose of owning, holding, and managing real estate. It owns an office building and certain securities. The office building is let to tenants, to whom light and heat are furnished, and for whom janitor and similar service are performed.

The Fifty Associates are operating under a charter to own real estate, with power to build, improve, alter, pull down, and rebuild, and to manage, exchange and dispose of the same.

The Clark Iron Company was organized under the laws of Minnesota, owns and leases ore lands for the purpose of carrying on mining operations, and receives a royalty depending upon the quantity of ore mined.

The Boston Wharf Company is operating under a [220 U.S. 171] charter authorizing it to acquire lands and flats, with their privileges and appurtenances, and to lease, manage, and improve its property in whatever manner shall be deemed expedient by it, and to receive dockage and wharfage for vessels laid at its wharfs.

What we have said as to the character of the corporation tax as an excise disposes of the contention that it is direct, and therefore requiring apportionment by the Constitution. It remains to consider whether these corporations are engaged in business. "Business" is a very comprehensive term and embraces everything about which a person can be employed. Black's Law Dict. 158, citing *People ex Rel. Hoyt v. Tax Comm'rs,* 23 N.Y. 242, 244. "That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit." 1 Bouvier's Law Dict. p. 273.

We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings, making investments of profits, or leasing ore lands and collecting royalties, managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute, and in the capacity necessary to make such organizations subject to the law.

Of the *Motor Taximeter Cab Company* case, No. 432, the company owns and leases taxicabs, and collects rents therefrom. We think it is also doing business within the meaning of the statute.

What we have already said disposes of the objections made in certain cases of life insurance and trust companies, and banks, as to income derived from United States, state, municipal, or other nontaxable bonds.

We come to the question is a so-called public service corporation, such as the Coney Island and Brooklyn Railroad Company, in case No. 409, and the Interborough [220 U.S. 172] Rapid Transit Company, No. 442, exempted from the operation of this statute? In the case of *South Carolina v. United States,* 199 U.S. 437, this Court held that, when a state, acting within its lawful authority, undertook to carry on the liquor business, it did not withdraw the agencies of the state, carrying on the traffic, from the operation of the internal revenue laws of the United States. If a state may not thus withdraw from the operation of a federal taxing law a subject matter of such taxation, it is difficult to see how the incorporation of companies whose service, though of a public nature, is nevertheless with a view to private profit, can have the effect of denying the federal right to reach such properties and activities for the purposes of revenue.

It is no part of the essential governmental functions of a state to provide means of transportation, supply artificial light, water, and the like. These objects are often accomplished through the medium of private corporations, and though the public may derive a benefit from such operations, the companies carrying on such enterprises are nevertheless private companies, whose business is prosecuted for private emolument and advantage. For the purpose of taxation, they stand upon the same footing as other private corporations upon which special franchises have been conferred.

The true distinction is between the attempted taxation of those operations of the states essential to the execution of its governmental functions, and which the state can only do itself, and those activities which are of a private character. The former, the United States may not interfere with by taxing the agencies of the state in carrying out its purposes; the latter, although regulated by the state, and exercising delegated authority, such as the right of eminent domain, are not removed from the field of legitimate federal taxation.

Applying this principle, we are of opinion that the [220 U.S. 173] so-called public service corporations represented in the cases at bar are not exempt from the tax in question. *Railroad Co. v. Peniston,* 18 Wall. 5, 33.

It is again objected that incomes under $5,000 are exempted from the tax. It is only necessary, in this connection, to refer to *Knowlton v. Moore,* 178 U.S., *supra,* in which a tax upon inheritances in excess of $10,000 was sustained. In *Magoun v. Illinois Trust & Savings Bank,* 170 U.S. 283, 293, a graded inheritance tax was sustained.

As to the objections that certain organizations -- labor, agricultural, and horticultural, fraternal and benevolent societies, loan and building associations, and those for religious, charitable, or educational purposes, are excepted from the operation of the law, we find nothing in them to invalidate the tax. As we have had frequent occasion to say, the decisions of this Court from an early date to the present time have emphasized the right of Congress to select the objects of excise taxation, and within this power to tax some and leave others untaxed must be included the right to make exemptions such as are found in this act.

Again, it is urged that Congress exceeded its power in permitting a deduction to be made of interest payments only in case of interest paid by banks and trust companies on deposits, and 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 the corporation or company. This provision may have been inserted with a view to prevent corporations from issuing a large amount of bonds in excess of the paid-up capital stock, and thereby distributing profits so as to avoid the tax. In any event, we see no reason why this method of ascertaining the deductions allowed should invalidate the act. Such details are not wholly arbitrary, and were deemed essential to practical operation. Courts cannot substitute their judgment [220 U.S. 174] for that of the legislature. In such matters, a wide range of discretion is allowed.

The argument that different corporations are so differently circumstanced in different states, and the operation of the law so unequal as to destroy it, is so fully met in the opinion in *Knowlton v. Moore,* 178 U.S., *supra,* that it is only necessary to make reference thereto. For this purpose, the law operates uniformly, geographically considered, throughout the United States, and in the same way wherever the subject matter is found. A liquor tax is not rendered unlawful as a revenue measure because it may yield nothing in those states which have prohibited the liquor traffic. No more is the present law unconstitutional because of inequality of operation owing to different local conditions.

Nor is the special objection tenable, made in some of the cases, that the corporations act as trustees, guardians, etc., under the authority of the laws or courts of the state. Such trustees are not the agents of the state government in a sense which exempts them from taxation because executing the necessary governmental powers of the state. The trustees receive their compensation from the interests served, and not from the public revenues of the state.

It is urged in a number of the cases that in a certain feature of the statute there is a violation of the Fourth Amendment of the Constitution, protecting against unreasonable searches and seizures. This amendment was adopted to protect against abuses in judicial procedure under the guise of law, which invade the privacy of persons in their homes, papers, and effects, and applies to criminal prosecutions and suits for penalties and forfeitures under the revenue laws. *Boyd v. United States,* 116 U.S. 632. It does not prevent the issue of search warrants for the seizure of gambling paraphernalia and other illegal matter. *Adams v. New York,* 192 U.S. 585. It does not prevent the issuing of process to require attendance [220 U.S. 175] and testimony of witnesses, the production of books and papers, etc. *Interstate Commerce Commission v. Brimson,* 154 U.S. 447; *Interstate Commerce Commission v. Baird,* 194 U.S. 25. Certainly the amendment was not intended to prevent the ordinary procedure in use in many, perhaps most, of the states, of requiring tax returns to be made, often under oath. The objection in this connection applies, when the substance of the argument is reached, to the sixth section of § 38 of the act, which provides:

> Sixth. When the assessment shall be made, as provided in this section, the returns, together with any corrections thereof which may have been made by the commissioner, shall be filed in the office of the Commissioner of Internal Revenue, and shall constitute public records, and be open to inspection as such.

An amendment was made June 17, 1910, which reads as follows:

> For classifying, indexing, exhibiting, and properly caring for the returns of all corporations, required by section thirty-eight of an act entitled, "An Act to Provide Revenue, Equalize Duties, Encourage the Industries of the United States, and for Other Purposes," approved August fifth, nineteen hundred and nine, including the employment in the District of Columbia of such clerical and other personal services and for rent of such quarters as may be necessary, twenty-five thousand dollars: *Provided,* That any and all such returns shall be open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President.

The contention is that the above section as originally framed and as now amended could have no legitimate connection with the collection of the tax, and in substance amounts to no more than an unlawful attempt to exhibit the private affairs of corporations to public or private inspection, without any substantial connection with or [220 U.S. 176] legitimate purpose to be subserved in the collection of the tax under the act now under consideration. But we cannot agree to this contention. The taxation being, as we have held, within the legitimate powers of Congress, it is for that body to determine what means are appropriate and adapted to the purposes of making the law effectual. In this connection, the often-quoted declaration of Chief Justice Marshall in *McCulloch v. Maryland,* 4 Wheat. 316, 421, is appropriate:

> Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the Constitution, are constitutional.

Congress may have deemed the public inspection of such returns a means of more properly securing the fullness and accuracy thereof. In many of the states, laws are to be found making tax returns public documents, and open to inspection.{3} [220 U.S. 177]

We cannot say that this feature of the law does violence to the constitutional protection of the Fourth Amendment, and, this is equally true of the Fifth Amendment, protecting persons against compulsory self-incriminating testimony. No question under the latter Amendment properly arises in these cases, and when circumstances are presented which invoke the protection of that Amendment, and raise questions involving rights thereby secured, it will be time enough to decide them. And so of the argument that the penalties for the nonpayment of the taxes are so high as to violate the Constitution. No case is presented involving that question, and, moreover, the penalties are clearly a separate part of the act, and whether collectible or not may be determined in a case involving an attempt to enforce them. *Willcox v. Consolidated Gas Co.,* 212 U.S. 19, 53.

It has been suggested that there is a lack of power to tax foreign corporations, doing local business in a state, in the manner proposed in this act, and that the tax upon such corporations, being unconstitutional, works such inequality against domestic corporations as to invalidate the law. It is sufficient to say to this that no such case is presented in the record. *Southern Railway Co. v. King,* 217 U.S. 525. This is equally true as to the alleged invalidity of the act as a tax on exports, which is beyond the power of Congress. No such case is presented in those now before the court.

We have noticed such objections as are made to the constitutionality of this law as it is deemed necessary to consider. Finding the statute to be within the constitutional power of the Congress, it follows that the judgments in the several cases must be affirmed.

Affirmed.

1. *Hylton v. United States,* 3 Dall. 171 (a tax on carriages which the owner kept for private use); *Nicol v. Ames, supra,* (a tax upon sales or exchanges of boards of trade); *Knowlton v. Moore, supra,* (a tax on the transmission of property from the dead to the living); *Treat v. White,* 181 U.S. 264 (a tax on agreements to sell shares of stock, denominated "calls" by stockbrokers); *Patton v. Brady,* 184 U.S. 608 (a tax on tobacco manufactured for consumption, and imposed at a period intermediate the commencement of manufacture and the final consumption of the article); *Cornell v. Coyne,* 192 U.S. 418 (a tax on "filled cheese" manufactured expressly for export); *McCray v. United States,* 195 U.S. 27 (a tax on oleomargarine not artificially colored, a higher tax on oleomargarine artificially colored, and no tax on butter artificially colored); *Thomas v. United States, supra,* (a tax on sales of shares of stock in corporations); *Pacific Ins. Co. v. Soule,* 7 Wall. 433 (a tax upon the amounts insured, renewed, or continued by insurance companies, upon the gross amounts of premiums received and assessments made by them, and also upon dividends, undistributed sums, and incomes); *Veazie Bank v. Fenno,* 8 Wall. 533 (a tax of ten percentum on the amount of the notes paid out of any state bank, or state banking association); *Scholey v. Rew,* 23 Wall. 331 (a tax on devolutions of title to real estate); *Spreckels v. Sugar Refining Co.,* 192 U.S. 397 (a tax on the gross receipts of corporations and companies, in excess of $250,000, engaged in refining sugar or oil); *Railroad Co. v. Collector,* 100 U.S. 595 (a tax laid in terms upon the amounts paid by certain public service corporations as interest on their funded debt, or as dividends to their stockholders, and also on "all profits, incomes, or gains of such company, and all profits of such company carried to the account of any fund, or used for construction." Held to be a tax upon the company's earnings, and therefore essentially an excise upon the business of the corporations); *Springer v. United States,* 102 U.S. 586 (a duty provided by the internal revenue acts to be assessed, collected, and paid upon gains, profits, and incomes, held to be an excise or duty, and not a direct tax).

2. *Beers v. Glynn,* 211 U.S. 477 (a state tax on personalty of nonresident decedents who owned realty in the state); *Hatch v. Reardon,* 204 U.S. 152 (a state tax on the transfers of stock made within the state); *Armour Packing Co. v. Lacy,* 200 U.S. 226 (a state license tax on meat-packing houses. A foreign corporation selling its products in the state, but whose packing establishments are not situated in the state, is not exempt from such license tax); *Savannah, Thunderbolt & Isle of Hope Railway v. Savannah,* 198 U.S. 392 (a classification which distinguishes between an ordinary street railway and a steam railroad, making an extra charge for local deliveries of freight brought over its road from outside the city, held not to be such a classification as to make the tax void under the Fourteenth Amendment); *Cook v. Marshall County,* 196 U.S. 261 (a state tax on cigarette dealers); *Magoun v. Illinois Trust & Savings Bank,* 170 U.S. 283 (upholding the graded inheritance tax law of Illinois); *Bell's Gap Railroad Co. v. Pennsylvania,* 134 U.S. 232 (state tax upon the nominal face value of bonds, instead of their actual value, held a valid part of the state system of taxation).

3. In Connecticut, the requirement is that the tax lists of the assessors shall be abstracted and lodged in the town clerk's office "for public inspection." R.S.Conn., § 2310. In New York, notices of the completion of the assessment

rolls must be conspicuously posted in three or more public places, and a copy left in a specified place, "where it may be seen and examined by any person until the third Tuesday of August next following." Consol.Laws of N.Y. vol. 5, p. 5859; N.Y.Laws 1909, c. 62, § 36. In Maryland, a record of property assessed is required to be kept, and the valuation thereof, with alphabetical list of owners, recorded in a book, "which any person may inspect without fee or reward." Pub.Laws Md., vol. 2, p. 1804, § 23. In Pennsylvania, it is provided that from the time of publishing the assessor's returns until the day appointed for finally determining whether the assessor's valuations are too low, "any taxable inhabitant of the county shall have the right to examine the said return in the commissioner's office." Pepper & Lewis' Dig.Laws Pa., vol. 2, p. 4591, § 357. In New Hampshire, the list of taxes assessed are required to be kept in a book, and also left with the town clerk, and such records "shall be open to the inspection of all persons." Pub.Stat.N.H., 1901, p. 214, § 5.

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§ 7701. Definitions

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(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) Person

The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(2) Partnership and partner

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) Corporation

The term "corporation" includes associations, joint-stock companies, and insurance companies.

(4) Domestic

The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

(5) Foreign

The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) Fiduciary

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) Stock

The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) Shareholder

The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(9) United States

The term "United States" when used in a geographical sense includes only the States and the District of Columbia.

(10) State

The term "State" shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) Secretary of the Treasury and Secretary

(A) Secretary of the Treasury

The term "Secretary of the Treasury" means the Secretary of the Treasury, personally, and shall not include any delegate of his.

(B) Secretary

The term "Secretary" means the Secretary of the Treasury or his delegate.

(12) Delegate

(A) In general

The term "or his delegate"—

(i) when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context; and

(ii) when used with reference to any other official of the United States, shall be similarly construed.

(B) Performance of certain functions in Guam or American Samoa

The term "delegate," in relation to the performance of functions in Guam or American Samoa with respect to the taxes imposed by chapters 1, 2, and 21, also includes any officer or employee of any other department or agency of the United States, or of any possession thereof, duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform such functions.

(13) Commissioner

The term “Commissioner” means the Commissioner of Internal Revenue.

(14) Taxpayer

The term “taxpayer” means any person subject to any internal revenue tax.

(15) Military or naval forces and armed forces of the United States

The term “military or naval forces of the United States” and the term “Armed Forces of the United States” each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

(16) Withholding agent

The term “withholding agent” means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

(17) Husband and wife

As used in sections 682 and 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term “wife” shall be read “former wife” and the term “husband” shall be read “former husband”; and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term “husband” shall be read “wife” and the term “wife” shall be read “husband.”

(18) International organization

The term “international organization” means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288–288f).

(19) Domestic building and loan association

The term “domestic building and loan association” means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which either (i) is an insured institution within the meaning of section 401(a) [1] of the National Housing Act (12 U.S.C., sec. 1724 (a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, but only in the proportion which the assets of such REMIC consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC are assets described in clauses (i) through (x), the entire interest in the REMIC shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property’s planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of clause (xi).

(20) Employee

For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104, 105, and 106 with respect to accident and health insurance or accident and health plans, and for the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, and for purposes of applying section 125 with respect to cafeteria plans, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of chapter 21, or in the case of services performed before January 1, 1951, who would be considered an employee if his services were performed during 1951.

(21) Levy

The term "levy" includes the power of distraint and seizure by any means.

(22) Attorney General

The term "Attorney General" means the Attorney General of the United States.

(23) Taxable year

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary, the period for which such return is made.

(24) Fiscal year

The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

(25) Paid or incurred, paid or accrued

The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.

(26) Trade or business

The term "trade or business" includes the performance of the functions of a public office.

(27) Tax Court

The term "Tax Court" means the United States Tax Court.

(28) Other terms

Any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as in such provisions.

(29) Internal Revenue Code

The term "Internal Revenue Code of 1986" means this title, and the term "Internal Revenue Code of 1939" means the Internal Revenue Code enacted February 10, 1939, as amended.

(30) United States person

The term "United States person" means—

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and

(E) any trust if—

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

(31) Foreign estate or trust

(A) Foreign estate

The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

(B) Foreign trust

The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).

(32) Cooperative bank

The term "cooperative bank" means an institution without capital stock organized and operated for mutual purposes and without profit, which—

(A) either—

(i) is an insured institution within the meaning of section 401 (a) [2] of the National Housing Act (12 U.S.C., sec. 1724 (a)), or

(ii) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B) and (C) of paragraph (19) of this subsection (relating to definition of domestic building and loan association).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution.

(33) Regulated public utility

The term "regulated public utility" means—

(A) A corporation engaged in the furnishing or sale of—

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission.

(C) A corporation engaged as a common carrier

(i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Surface Transportation Board, or

(ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Secretary of Transportation.

(F) A corporation engaged in the furnishing or sale of transportation by a water carrier subject to jurisdiction under subchapter II of chapter 135 of title 49.

(G) A rail carrier subject to part A of subtitle IV of title 49, if

(i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before January 1, 1954,

(ii) each lease is for a term of more than 20 years, and

(iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

(H) A common parent corporation which is a common carrier by railroad subject to part A of subtitle IV of title 49 if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

The term "regulated public utility" does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F), inclusive. If the taxpayer establishes to the satisfaction of the Secretary that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D).

[(34) Repealed. Pub. L. 98–369, div. A, title IV, §•4112(b)(11), July 18, 1984, 98 Stat. 792]

(35) Enrolled actuary

The term "enrolled actuary" means a person who is enrolled by the Joint Board for the Enrollment of Actuaries established under subtitle C of the title III of the Employee Retirement Income Security Act of 1974.

(36) Income tax return preparer

(A) In general

The term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

(B) Exceptions

A person shall not be an "income tax return preparer" merely because such person—

(i) furnishes typing, reproducing, or other mechanical assistance,

(ii) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(iii) prepares as a fiduciary a return or claim for refund for any person, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

(37) Individual retirement plan

The term "individual retirement plan" means—

(A) an individual retirement account described in section 408 (a), and

(B) an individual retirement annuity described in section 408 (b).

(38) Joint return

The term "joint return" means a single return made jointly under section 6013 by a husband and wife.

(39) Persons residing outside United States

If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of any provision of this title relating to—

(A) jurisdiction of courts, or

(B) enforcement of summons.

(40) Indian tribal government

(A) In general

The term "Indian tribal government" means the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary, after consultation with the Secretary of the Interior, to exercise governmental functions.

(B) Special rule for Alaska Natives

No determination under subparagraph (A) with respect to Alaska Natives shall grant or defer any status or powers other than those enumerated in section 7871. Nothing in the Indian Tribal Governmental Tax Status Act of 1982, or in the amendments made thereby, shall validate or invalidate any claim by Alaska Natives of sovereign authority over lands or people.

(41) TIN

The term "TIN" means the identifying number assigned to a person under section 6109.

(42) Substituted basis property

The term "substituted basis property" means property which is—

(A) transferred basis property, or

(B) exchanged basis property.

(43) Transferred basis property

The term “transferred basis property” means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) Exchanged basis property

The term “exchanged basis property” means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) Nonrecognition transaction

The term “nonrecognition transaction” means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

(46) Determination of whether there is a collective bargaining agreement

In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term “employee representatives” shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer. An agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and 1 or more employers.

(47) Executor

The term “executor” means the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent.

(48) Off-highway vehicles

(A) Off-highway transportation vehicles

(i) In general A vehicle shall not be treated as a highway vehicle if such vehicle is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design such vehicle’s capability to transport a load over the public highway is substantially limited or impaired.

(ii) Determination of vehicle’s design For purposes of clause (i), a vehicle’s design is determined solely on the basis of its physical characteristics.

(iii) Determination of substantial limitation or impairment For purposes of clause (i), in determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether such vehicle is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether such vehicle can transport a load at a sustained speed of at least 25 miles per hour. It is immaterial that a vehicle can transport a greater load off the public highway than such vehicle is permitted to transport over the public highway.

(B) Nontransportation trailers and semitrailers

A trailer or semitrailer shall not be treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an off-highway function at an off-highway site.

(b) Definition of resident alien and nonresident alien

(1) In general

For purposes of this title (other than subtitle B)—

(A) Resident alien

An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i), (ii), or (iii):

(i) Lawfully admitted for permanent residence Such individual is a lawful permanent resident of the United States at any time during such calendar year.

(ii) Substantial presence test Such individual meets the substantial presence test of paragraph (3).

(iii) First year election Such individual makes the election provided in paragraph (4).

(B) Nonresident alien

An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

(2) Special rules for first and last year of residency

(A) First year of residency

(i) In general If an alien individual is a resident of the United States under paragraph (1)(A) with respect to any calendar year, but was not a resident of the United States at any time during the preceding calendar year, such alien individual shall be treated as a resident of the United States only for the portion of such calendar year which begins on the residency starting date.

(ii) Residency starting date for individuals lawfully admitted for permanent residence In the case of an individual who is a lawfully permanent resident of the United States at any time during the calendar year, but does not meet the substantial presence test of paragraph (3), the residency starting date shall be the first day in such calendar year on which he was present in the United States while a lawful permanent resident of the United States.

(iii) Residency starting date for individuals meeting substantial presence test In the case of an individual who meets the substantial presence test of paragraph (3) with respect to any calendar year, the residency starting date shall be the first day during such calendar year on which the individual is present in the United States.

(iv) Residency starting date for individuals making first year election In the case of an individual who makes the election provided by paragraph (4) with respect to any calendar year, the residency starting date shall be the 1st day during such calendar year on which the individual is treated as a resident of the United

States under that paragraph.

(B) Last year of residency

An alien individual shall not be treated as a resident of the United States during a portion of any calendar year if—

(i) such portion is after the last day in such calendar year on which the individual was present in the United States (or, in the case of an individual described in paragraph (1)(A)(i), the last day on which he was so described),

(ii) during such portion the individual has a closer connection to a foreign country than to the United States, and

(iii) the individual is not a resident of the United States at any time during the next calendar year.

(C) Certain nominal presence disregarded

(i) In general For purposes of subparagraphs (A)(iii) and (B), an individual shall not be treated as present in the United States during any period for which the individual establishes that he has a closer connection to a foreign country than to the United States.

(ii) Not more than 10 days disregarded Clause (i) shall not apply to more than 10 days on which the individual is present in the United States.

(3) Substantial presence test

(A) In general

Except as otherwise provided in this paragraph, an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this subsection referred to as the "current year") if—

(i) such individual was present in the United States on at least 31 days during the calendar year, and

(ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

The applicable In the case of days in: multiplier is: Current year 1 1st preceding year 1/3 2nd preceding year 1/6

(B) Exception where individual is present in the United States during less than one-half of current year and closer connection to foreign country is established

An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if—

(i) such individual is present in the United States on fewer than 183 days during the current year, and

(ii) it is established that for the current year such individual has a tax home (as defined in section 911 (d)(3) without regard to the second sentence thereof) in a foreign country and has a closer connection to such foreign country than to the United States.

(C) Subparagraph (B) not to apply in certain cases

Subparagraph (B) shall not apply to any individual with respect to any current year if at any time during such year—

(i) such individual had an application for adjustment of status pending, or

(ii) such individual took other steps to apply for status as a lawful permanent resident of the United States.

(D) Exception for exempt individuals or for certain medical conditions

An individual shall not be treated as being present in the United States on any day if—

(i) such individual is an exempt individual for such day, or

(ii) such individual was unable to leave the United States on such day because of a medical condition which arose while such individual was present in the United States.

(4) First-year election

(A) An alien individual shall be deemed to meet the requirements of this subparagraph if such individual—

(i) is not a resident of the United States under clause (i) or (ii) of paragraph (1)(A) with respect to a calendar year (hereinafter referred to as the "election year"),

(ii) was not a resident of the United States under paragraph (1)(A) with respect to the calendar year immediately preceding the election year,

(iii) is a resident of the United States under clause (ii) of paragraph (1)(A) with respect to the calendar year immediately following the election year, and

(iv) is both—

(I) present in the United States for a period of at least 31 consecutive days in the election year, and

(II) present in the United States during the period beginning with the first day of such 31-day period and ending with the last day of the election year (hereinafter referred to as the "testing period") for a number of days equal to or exceeding 75 percent of the number of days in the testing period (provided that an individual shall be treated for purposes of this subclause as present in the United States for a number of days during the testing period not exceeding 5 days in the aggregate, notwithstanding his absence from the United States on such days).

(B) An alien individual who meets the requirements of subparagraph (A) shall, if he so elects, be treated as a resident of the United States with respect to the election year.

(C) An alien individual who makes the election provided by subparagraph (B) shall be treated as a resident of the United States for the portion of the election year which begins on the 1st day of the earliest testing period during such year with respect to which the individual meets the requirements of clause (iv) of subparagraph (A).

(D) The rules of subparagraph (D)(i) of paragraph (3) shall apply for purposes of determining an individual's presence in the United States under this paragraph.

(E) An election under subparagraph (B) shall be made on the individual’s tax return for the election year, provided that such election may not be made before the individual has met the substantial presence test of paragraph (3) with respect to the calendar year immediately following the election year.

(F) An election once made under subparagraph (B) remains in effect for the election year, unless revoked with the consent of the Secretary.

(5) Exempt individual defined

For purposes of this subsection—

(A) In general

An individual is an exempt individual for any day if, for such day, such individual is—

(i) a foreign government-related individual,

(ii) a teacher or trainee,

(iii) a student, or

(iv) a professional athlete who is temporarily in the United States to compete in a charitable sports event described in section 274 (l)(1)(B).

(B) Foreign government-related individual

The term “foreign government-related individual” means any individual temporarily present in the United States by reason of—

(i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,

(ii) being a full-time employee of an international organization, or

(iii) being a member of the immediate family of an individual described in clause (i) or (ii).

(C) Teacher or trainee

The term “teacher or trainee” means any individual—

(i) who is temporarily present in the United States under subparagraph (J) or (Q) of section 101(15) of the Immigration and Nationality Act (other than as a student), and

(ii) who substantially complies with the requirements for being so present.

(D) Student

The term “student” means any individual—

(i) who is temporarily present in the United States—

(I) under subparagraph (F) or (M) of section 101(15) of the Immigration and Nationality Act, or

(II) as a student under subparagraph (J) or (Q) of such section 101 (15), and

(ii) who substantially complies with the requirements for being so present.

(E) Special rules for teachers, trainees, and students

(i) Limitation on teachers and trainees An individual shall not be treated as an exempt individual by reason of clause (ii) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A). In the case of an individual all of whose compensation is described in section 872 (b)(3), the preceding sentence shall be applied by substituting "4 calendar years" for "2 calendar years".

(ii) Limitation on students For any calendar year after the 5th calendar year for which an individual was an exempt individual under clause (ii) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (D)(ii).

(6) Lawful permanent resident

For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if—

(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

(B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

(7) Presence in the United States

For purposes of this subsection—

(A) In general

Except as provided in subparagraph (B), (C), or (D), an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.

(B) Commuters from Canada or Mexico

If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

(C) Transit between 2 foreign points

If an individual, who is in transit between 2 points outside the United States, is physically present in the United States for less than 24 hours, such individual shall not be treated as present in the United States on any day during such transit.

(D) Crew members temporarily present

An individual who is temporarily present in the United States on any day as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States shall not be treated as present in the United States on such day unless such individual otherwise engages in any trade or business in the United States on such day.

(8) Annual statements

The Secretary may prescribe regulations under which an individual who (but for subparagraph (B) or (D) of paragraph (3)) would meet the substantial presence test of paragraph (3) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B) or (D) of paragraph (3), as the case may be.

(9) Taxable year

(A) In general

For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

(B) Fiscal year taxpayer

If—

(i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and

(ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year,

he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year.

(10) Coordination with section 877

If—

(A) an alien individual was treated as a resident of the United States during any period which includes at least 3 consecutive calendar years (hereinafter referred to as the "initial residency period"), and

(B) such individual ceases to be treated as a resident of the United States but subsequently becomes a resident of the United States before the close of the 3rd calendar year beginning after the close of the initial residency period,

such individual shall be taxable for the period after the close of the initial residency period and before the day on which he subsequently became a resident of the United States in the manner provided in section 877 (b). The preceding sentence shall apply only if the tax imposed pursuant to section 877 (b) exceeds the tax which, without regard to this paragraph, is imposed pursuant to section 871.

(11) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(c) Includes and including

The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.

(d) Commonwealth of Puerto Rico

Where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, references in this title to possessions of the United States shall be treated as also referring to the Commonwealth of Puerto Rico.

(e) Treatment of certain contracts for providing services, etc.

For purposes of chapter 1—

(1) In general

A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not —

(A) the service recipient is in physical possession of the property,

(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,

(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

(2) Other arrangements

An arrangement (including a partnership or other pass-thru entity) which is not described in paragraph (1) shall be treated as a lease if such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in paragraph (1).

(3) Special rules for contracts or arrangements involving solid waste disposal, energy, and clean water facilities

(A) In general

Notwithstanding paragraphs (1) and (2), and except as provided in paragraph (4), any contract or arrangement between a service provider and a service recipient—

(i) with respect to—

(I) the operation of a qualified solid waste disposal facility,

(II) the sale to the service recipient of electrical or thermal energy produced at a cogeneration or alternative energy facility, or

(III) the operation of a water treatment works facility, and

(ii) which purports to be a service contract,

shall be treated as a service contract.

(B) Qualified solid waste disposal facility

For purposes of subparagraph (A), the term “qualified solid waste disposal facility” means any facility if such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public.

(C) Cogeneration facility

For purposes of subparagraph (A), the term "cogeneration facility" means a facility which uses the same energy source for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy.

(D) Alternative energy facility

For purposes of subparagraph (A), the term "alternative energy facility" means a facility for producing electrical or thermal energy if the primary energy source for the facility is not oil, natural gas, coal, or nuclear power.

(E) Water treatment works facility

For purposes of subparagraph (A), the term "water treatment works facility" means any treatment works within the meaning of section 212(2) of the Federal Water Pollution Control Act.

(4) Paragraph (3) not to apply in certain cases

(A) In general

Paragraph (3) shall not apply to any qualified solid waste disposal facility, cogeneration facility, alternative energy facility, or water treatment works facility used under a contract or arrangement if—

(i) the service recipient (or a related entity) operates such facility,

(ii) the service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement (other than for reasons beyond the control of the service provider),

(iii) the service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement, or

(iv) the service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or a part of such facility at a fixed and determinable price (other than for fair market value).

For purposes of this paragraph, the term "related entity" has the same meaning as when used in section 168 (h).

(B) Special rules for application of subparagraph (A) with respect to certain rights and allocations under the contract

For purposes of subparagraph (A), there shall not be taken into account—

(i) any right of a service recipient to inspect any facility, to exercise any sovereign power the service recipient may possess, or to act in the event of a breach of contract by the service provider, or

(ii) any allocation of any financial burden or benefits in the event of any change in any law.

(C) Special rules for application of subparagraph (A) in the case of certain events

(i) Temporary shut-downs, etc. For purposes of clause (ii) of subparagraph (A), there shall not be taken into account any temporary shut-down of the facility for repairs, maintenance, or capital improvements, or any financial burden caused by the bankruptcy or similar financial difficulty of the service provider.

(ii) Reduced costs For purposes of clause (iii) of subparagraph (A), there shall not be taken into account any significant financial benefit merely because payments by the service recipient under the contract or arrangement are decreased by reason of increased production or efficiency or the recovery of energy or other products.

(5) Exception for certain low-income housing

This subsection shall not apply to any property described in clause (i), (ii), (iii), or (iv) of section 1250 (a)(1)(B) (relating to low-income housing) if—

(A) such property is operated by or for an organization described in paragraph (3) or (4) of section 501 (c), and

(B) at least 80 percent of the units in such property are leased to low-income tenants (within the meaning of section 167 (k)(3)(B)) (as in effect on the day before the date of the enactment of the Revenue Reconcilation [3] Act of 1990).

(6) Regulations

The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this subsection.

(f) Use of related persons or pass-thru entities

The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with—

(1) the linking of borrowing to investment, or

(2) diminishing risks,

through the use of related persons, pass-thru entities, or other intermediaries.

(g) Clarification of fair market value in the case of nonrecourse indebtedness

For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

(h) Motor vehicle operating leases

(1) In general

For purposes of this title, in the case of a qualified motor vehicle operating agreement which contains a terminal rental adjustment clause —

(A) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and

(B) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect.

(2) Qualified motor vehicle operating agreement defined

For purposes of this subsection—

(A) In general

The term "qualified motor vehicle operating agreement" means any agreement with respect to a motor vehicle (including a trailer) which meets the requirements of subparagraphs (B), (C), and (D) of this paragraph.

(B) Minimum liability of lessor

An agreement meets the requirements of this subparagraph if under such agreement the sum of—

(i) the amount the lessor is personally liable to repay, and

(ii) the net fair market value of the lessor's interest in any property pledged as security for property subject to the agreement,

equals or exceeds all amounts borrowed to finance the acquisition of property subject to the agreement. There shall not be taken into account under clause (ii) any property pledged which is property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement.

(C) Certification by lessee; notice of tax ownership

An agreement meets the requirements of this subparagraph if such agreement contains a separate written statement separately signed by the lessee—

(i) under which the lessee certifies, under penalty of perjury, that it intends that more than 50 percent of the use of the property subject to such agreement is to be in a trade or business of the lessee, and

(ii) which clearly and legibly states that the lessee has been advised that it will not be treated as the owner of the property subject to the agreement for Federal income tax purposes.

(D) Lessor must have no knowledge that certification is false

An agreement meets the requirements of this subparagraph if the lessor does not know that the certification described in subparagraph (C)(i) is false.

(3) Terminal rental adjustment clause defined

(A) In general

For purposes of this subsection, the term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

(B) Special rule for lessee dealers

The term "terminal rental adjustment clause" also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provision achieves substantially the same results as a provision described in subparagraph (A).

(i) Taxable mortgage pools

(1) Treated as separate corporations

A taxable mortgage pool shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of section 1501.

(2) Taxable mortgage pool defined

For purposes of this title—

(A) In general

Except as otherwise provided in this paragraph, a taxable mortgage pool is any entity (other than a REMIC) if—

(i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein),

(ii) such entity is the obligor under debt obligations with 2 or more maturities, and

(iii) under the terms of the debt obligations referred to in clause (ii) (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the debt obligations (or interests) referred to in clause (i).

(B) Portion of entities treated as pools

Any portion of an entity which meets the definition of subparagraph (A) shall be treated as a taxable mortgage pool.

(C) Exception for domestic building and loan

Nothing in this subsection shall be construed to treat any domestic building and loan association (or portion thereof) as a taxable mortgage pool.

(D) Treatment of certain equity interests

To the extent provided in regulations, equity interest of varying classes which correspond to maturity classes of debt shall be treated as debt for purposes of this subsection.

(3) Treatment of certain REIT’s

If—

(A) a real estate investment trust is a taxable mortgage pool, or

(B) a qualified REIT subsidiary (as defined in section 856(i)(2)) of a real estate investment trust is a taxable mortgage pool,

under regulations prescribed by the Secretary, adjustments similar to the adjustments provided in section 860E (d) shall apply to the shareholders of such real estate investment trust.

(j) Tax treatment of Federal Thrift Savings Fund

(1) In general

For purposes of this title—

(A) the Thrift Savings Fund shall be treated as a trust described in section 401 (a) which is exempt from taxation under section 501 (a);

(B) any contribution to, or distribution from, the Thrift Savings Fund shall be treated in the same manner as contributions to or distributions from such a trust; and

(C) subject to section 401 (k)(4)(B) and any dollar limitation on the application of section 402 (e)(3), contributions to the Thrift Savings Fund shall not be treated as distributed or made available to an employee or Member nor as a contribution made to the Fund by an employee or Member merely because the employee or Member has, under the provisions of subchapter III of chapter 84 of title 5, United States Code, and section 8351 of such title 5, an election whether the contribution will be made to the Thrift Savings Fund or received by the employee or Member in cash.

(2) Nondiscrimination requirements

Notwithstanding any other provision of law, the Thrift Savings Fund is not subject to the nondiscrimination requirements applicable to arrangements described in section 401 (k) or to matching contributions (as described in section 401 (m)), so long as it meets the requirements of this section.

(3) Coordination with Social Security Act

Paragraph (1) shall not be construed to provide that any amount of the employee's or Member's basic pay which is contributed to the Thrift Savings Fund shall not be included in the term "wages" for the purposes of section 209 of the Social Security Act or section 3121 (a) of this title.

(4) Definitions

For purposes of this subsection, the terms "Member", "employee", and "Thrift Savings Fund" shall have the same respective meanings as when used in subchapter III of chapter 84 of title 5, United States Code.

(5) Coordination with other provisions of law

No provision of law not contained in this title shall apply for purposes of determining the treatment under this title of the Thrift Savings Fund or any contribution to, or distribution from, such Fund.

(k) Treatment of certain amounts paid to charity

In the case of any payment which, except for section 501(b) of the Ethics in Government Act of 1978, might be made to any officer or employee of the Federal Government but which is made instead on behalf of such officer or employee to an organization described in section 170 (c)—

(1) such payment shall not be treated as received by such officer or employee for all purposes of this title and for all purposes of any tax law of a State or political subdivision thereof, and

(2) no deduction shall be allowed under any provision of this title (or of any tax law of a State or political subdivision thereof) to such officer or employee by reason of having such payment made to such organization.

For purposes of this subsection, a Senator, a Representative in, or a Delegate or Resident Commissioner to, the Congress shall be treated as an officer or employee of the Federal Government.

(l) Regulations relating to conduit arrangements

The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.

(m) Designation of contract markets

Any designation by the Commodity Futures Trading Commission of a contract market which could not have been made under the law in effect on the day before the date of the enactment of the Commodity Futures Modernization Act of 2000 shall apply for purposes of this title except to the extent provided in regulations prescribed by the Secretary.

(n) Special rules for determining when an individual is no longer a United States citizen or long-term resident

An individual who would (but for this subsection) cease to be treated as a citizen or resident of the United States shall continue to be treated as a citizen or resident of the United States, as the case may be, until such individual—

(1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, and

(2) provides a statement in accordance with section 6039G.

(o) Cross references

(1) Other definitions

For other definitions, see the following sections of Title 1 of the United States Code:

(1) Singular as including plural, section 1.

(2) Plural as including singular, section 1.

(3) Masculine as including feminine, section 1.

(4) Officer, section 1.

(5) Oath as including affirmation, section 1.

(6) County as including parish, section 2.

(7) Vessel as including all means of water transportation, section 3.

(8) Vehicle as including all means of land transportation, section 4.

(9) Company or association as including successors and assigns, section 5.

(2) Effect of cross references

For effect of cross references in this title, see section 7806 (a).

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[1] See References in Text note below.

[2] See References in Text note below.

[3] So in original. Probably should be "Reconciliation".

CITES BY TOPIC: includes and including

WORDS AND PHRASES: "INCLUDE" -detailed analysis of the word "include" from THE AUTHORITY

Black's Law Dictionary, Sixth Edition, page 763 (1990):

> "**Include**. (Lat. Inclaudere, to shut in. keep within.) To confine within, hold as an inclosure. Take in, attain, shut up, contain, inclose, comprise, comprehend, embrace, involve. Term may, according to context, express an enlargement and have the meaning of and or in addition to, or merely specify a particular thing already included within general words theretofore used. "Including" within statute is interpreted as a word of enlargement or of illustrative application as well as a word of limitation. Premier Products Co. v. Cameron, 240 Or. 123, 400 P.2d 227, 228."

Bouvier's Law Dictionary, 1856, Sixth Edition:

> "INCLUDE (Lat. in claudere to shut in, keep within). In a legacy of 'one hundred dollars including money trusted' at a bank, it was held that the word `including' extended only to a gift of one hundred dollars; 132 Mass. 218..."
>
> "INCLUDING. The words `and including' following a description do not necessarily mean `in addition to,' but may refer to a part of the thing described. 221 U.S. 425."

Meaning of the words "include" and "including"-exhaustive and authoritative analysis of the meaning and use of the words "includes" and "including" within law

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26 U.S.C. Sec. 7701(c) INCLUDES AND INCLUDING.

> The terms 'include' and 'including' when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined."

Other terms defined in the Internal Revenue Code which rely on the word "includes":

Term	*Where defined*
"employee"	26 U.S.C. §3401(c), 26 CFR §31.3401(c)-1
"gross income"	26 U.S.C. §872

"person"	26 U.S.C. §7701(a)(1), 26 U.S.C. §7343, 26 CFR 301.6671-1
"State"	26 U.S.C. §7701(a)(10)
"trade or business"	26 U.S.C. §7701(a)(26)
"United States"	26 U.S.C. §7701(a)(9)

Black's Law Dictionary, Sixth Edition, page 581:

> "**Expressio unius est exclusio alterius**. A maxim of statutory interpretation meaning that **the expression of one thing is the exclusion of another.** Burgin v. Forbes, 293 Ky. 456, 169 S.W.2d 321, 325; Newblock v. Bowles, 170 Okl. 487, 40 P.2d 1097, 1100. Mention of one thing implies exclusion of another. **When certain persons or things are specified in a law, contract, or will, an intention to exclude all others from its operation may be inferred.** Under this maxim, if statute specifies one exception to a general rule or assumes to specify the effects of a certain provision, other exceptions or effects are excluded." [Black's Law Dictionary, Sixth Edition, page 581]

U.S. Supreme Court examples of the use of the "expressio unius est exclusio alterius rule" cited above:

Tennesee Valley Auth. v. Hill, 437 U.S. 153, 188 (1978)
Passenger Corp. v. Passengers Assoc., 414 U.S. 453, 458 (1974)
Bingler v. Johnson, 394 U.S. 741, 749 (1969)
Evans v. Newton, 382 U.S. 296, 311 (1966)
Nashville Milk Co. v. Carnation Co., 355 U.S. 373, 375 (1958)

Black's Law Dictionary, Sixth Edition, page 517:

> "**Ejusdem generis.** Of the same kind, class, or nature. In the construction of laws, wills, and other instruments, the "ejusdem generis rule" is, that where general words follow an enumeration of persons or things, by words of a particular and specific meaning, such general words are not to be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned. U.S. v. LaBrecque, D.C. N.J., 419 F.Supp. 430, 432. The rule, however, does not necessarily require that the general provision be limited in its scope to the identical things specifically named. Nor does it apply when the context manifests a contrary intention.
>
> Under "ejusdem generis" cannon of statutory construction, where general words follow the enumeration of particular classes of things, the general words will be construed as applying only to things of the same general class as those enumerated. Campbell v. Board of Dental Examiners, 53 Cal.App.3d 283, 125 Cal.Rptr. 694, 696."

Federal Tax Research: Guide to Materials and Techniques, Copyright 1990, Fifth Edition, Gail Levin Richmond, ISBN 1-56662-457-6:

Rules of Statutory Construction for tax laws: "expressio unius, exclusio alterius"*:** if one or more items is specifically listed, omitted items are purposely excluded. See ***Becker v. United States, 451 U.S. 1306 (1981)

Montello Salt Co. v. Utah, 221 U.S. 452 (1911):

> "The determining word is, of course the word 'including.' It may have the sense of addition, [221 U.S. 452, 465] as we have seen, and of 'also;' but, we have also seen, 'may merely specify particularly that which belongs to the genus.' Hiller v. United States, 45 C. C. A. 229, 106 Fed. 73, 74. It is the participle of the word 'include,' which means, according to the definition of the Century Dictionary, (1) 'to confine within something; hold as in an inclosure; inclose; contain.' (2) 'To comprise as a part, or as something incident or pertinent; comprehend; take in; as the greater includes the less; . . . the Roman Empire included many nations.' 'Including,' being a participle, is in the nature of an adjective and is a modifier."
>
> ...
>
> "...***The court also considered that the word 'including' was used as a word of enlargement, the learned court being of opinion that such was its ordinary sense. With this we cannot concur. It is its exceptional sense, as the dictionaries and cases indicate.*** We may concede to 'and' the additive power attributed to it. It gives in connection with 'including' a quality to the grant of 110,000 acres which it would not have had,-the quality of selection from the saline lands of the state. And that such quality would not exist unless expressly conferred we do not understand is controverted. Indeed, it cannot be controverted...."

Treasury Decision 3980, Vol. 29, January-December, 1927, pgs. 64 and 65 defines the words **includes** and **including** as:

> "(1) **To comprise, comprehend, or embrace**…**(2) To enclose within; contain; confine**…But granting that the word '**including'** is a term of enlargement, it is clear that it **only** performs that office by introducing the **specific elements** constituting the enlargement. It thus, and thus **only**, enlarges the otherwise more **limited, preceding general language**…The word 'including' is obviously used in the sense of its **synonyms**, comprising; comprehending; embracing."

Powers ex re. Covon v. Charron R.I., 135 A. 2nd 829, 832 Definitions-Words and Phrases pages 156-156, Words and Phrases under '**limitations**'.

> "**Includes** is a word of **limitation**. Where a **general term** in Statute is followed by the word, '**including**' the primary import of the specific words following the quoted words is to indicate restriction rather than enlargement."

Gould v. Gould, 245 U.S. 151, at 153 (1917).

> "In the interpretation of **statutes levying taxes**, it is the established rule **not to** extend their provisions by implication

beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen."

[**NOTE**: See also American Net & Twine Co. v. Worthington, 141 U.S. 468, 35 L.ed. 821, 12 Sup. Ct. Rep. 55; United States v. Wigglesworth, 2 Story, 369, Fed. Cas. No. 16,690; Rice v. United States, 4 C. C. A. 104, 10 U. S. App.670, 53 Fed. 910, enziger v. United States, 192 U.S. 38, 55, 24 S. Sup. Ct.189.]

American Surety Co. of New York v. Marotta, 287 U.S. 513 (1933):

"**In definitive provisions of statutes and other writings, 'include' is frequently, if not generally, used as a word of extension or enlargement [meaning "in addition to"] rather than as one of limitation or enumeration.** Fraser v. Bentel, 161 Cal. 390, 394, 119 P. 509, Ann. Cas. 1913B, 1062; People ex rel. Estate of Woolworth v. S.T. Comm., 200 App.Div. 287, 289, 192 N.Y.S. 772; Matter of Goetz, 71 App.Div. 272, 275, 75 N.Y.S. 750; Calhoun v. Memphis & P.R. Co., Fed. Cas. No. 2,309; Cooper v. Stinson, 5 Minn. 522 (Gil. 416). Subject to the effect properly to be given to context, section 1 (11 USCA 1) prescribes the constructions to be put upon various words and phrases used in the act. Some of the definitive clauses commence with 'shall include,' others with 'shall mean.' The former is used in eighteen instances and the latter in nine instances, and in two both are used. When the section as a whole is regarded, it is evident that these verbs are not used synonymously or loosely, but with discrimination and a purpose to give to each a meaning not attributable to the other. It is obvious that, in some instances at least, 'shall include' is used without implication that any exclusion is intended. Subsections (6) and (7), in each of which both verbs are employed, illustrate the use of 'shall mean' to enumerate and restrict and of 'shall include' to enlarge and extend. Subsection (17) declares 'oath' shall include affirmation, Subsection (19) declares 'persons' shall include corporations, officers, partnerships, and women. Men are not mentioned. In these instances the verb is used to expand, not to restrict. It is plain that 'shall include,' as used in subsection (9) when taken in connection with other parts of the section, cannot reasonably be read to be the equivalent of 'shall mean' or 'shall include only.' [287 U.S. 513, 518] There being nothing to indicate any other purpose, Congress must be deemed to have intended that in section 3a(1) 'creditors' should be given the meaning usually attributed to it when used in the common-law definition of fraudulent conveyances. See Coder v. Arts, 213 U.S. 223, 242 , 29 S.Ct. 436, 16 Ann. Cas. 1008; Lansing Boiler & Engine Works v. Joseph T. Ryerson & Son (C.C.A.) 128 F. 701, 703; Githens v. Shiffler (D. C.) 112 F. 505. Under the common-law rule a creditor having only a contingent claim, such as was that of the petitioner at the time respondent made the transfer in question, is protected against fraudulent conveyance. And petitioner, from the time that it became surety on Mogliani's bond, was entitled as a creditor under the agreement to invoke that rule. Yeend v. Weeks, 104 Ala. 331, 341, 16 So. 165, 53 Am.St.Rep. 50; Whitehouse v. Bolster, 95 Me. 458, 50 A. 240; Mowry v. Reed, 187 Mass. 174, 177, 72 N.E. 936; Stone v. Myers, 9 Minn. 303 (Gil. 287, 294), 86 Am.Dec. 104; Cook v. Johnson, 12 N.J.Eq. 51, 72 Am.Dec. 381; American Surety Co. v. Hattrem, 138 Or. 358, 364, 3 P.(2d) 1109, 6 P.(2d) 1087; U.S. Fidelity & Guaranty Co. v. Centropolis Bank (C.C.A.) 17 F.(2d) 913, 916, 53 A.L.R. 295; Thomson v. Crane (C.C.) 73 F. 327, 331." [American Surety Co. of New York v. Marotta, 287 U.S. 513 (1933)]

NOTE: When the word "includes" is used as a word of *enlargement*, meaning "in addition to", the things that are in addition to it must be found in another section of the code somewhere. One may no "presume" what is included because presumption is a sin under Numbers 15:30 as well as a violation of due process which unfairly prejudices constitutional rights. Click here to learn why "presumption" violates due process of law

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Definitions - Words and Phrases page 156, under 'limitations'

"Includes is a word of limitation. Where a general term in statute is followed by the word, "including" the primary import of specific words following quoted words is to indicate restriction rather than enlargement." Powers ex rel Dovon v Charron R.I. 135 A. 2nd 829, 832

Hale v. Henkel, 201 U.S. 43 (1906):

"It may be that **it…is the obnoxious thing in its mildest and least repulsive form; but illegitimate and unconstitutional practices get their first footing in that way; namely, by silent approaches and slight deviations from legal modes of procedure. This can only be obviated by adhering to the rule that constitutional provisions for the security of person and property should be liberally construed.** A close and literal construction deprives them of half their efficacy, and leads to gradual depreciation of the right, as if it consisted more in sound than in substance. **It is the duty of the courts to be watchful for the constitutional rights of the citizens, and against any stealthy encroachments thereon.** Their motto should be obsta prinicpalis," [Mr. Justice Brewer, dissenting, quoting Mr. Justice Bradley in Boyd v. United States, 116 U.S. 616, 29 L.Ed. 746, 6 Sup.Ct.Rep. 524] [Hale v. Henkel, 201 U.S. 43 (1906)]

Springer v. Government of the Philippine Islands, 277 U.S. 189 (1928)

It is true that section 21 contains a specific provision that the Governor General shall appoint such officers as may now be appointed by the Governor General, or such as he is authorized by this act to appoint, or whom he may hereafter be authorized by law to appoint. And it is said that the effect of this is to confine the Governor General's powers of appointment within the limits of this enumeration. **The general rule that the expression of one thing is the exclusion of others is subject to exceptions. Like other canons of statutory construction, it is only an aid in the ascertainment of the meaning of the law, and must yield whenever a contrary intention on the part of the lawmaker is apparent. Where a statute contains a grant of power enumerating certain things which may be done and also a general grant of power which, standing alone, would include these things and more, the general grant may be given full effect if the context shows that the enumeration was not intended to be exclusive.** See, for example, Ford v. United States, 273 U.S. 593, 611 , 47 S. Ct. 531, Portland v. N. E. T. & T. Co., 103 Me. 240, 249, 68 A. 1040; Grubbe v. Grubbe, 26 Or. 363, 370, 38 P. 182; Swick v. Coleman, 218 Ill. 33, 40, 75 N. E. 807; Lexington ex rel. v. Commercial Bank, 130 Mo. App. 687, 692, 108 S. W. 1095; McFarland v. M., K. & T. Ry. Co., 94 Mo. App. 336, 342, 68 S. W. 105.

Bell v. United States, 349 U.S. 81 (1955)

When Congress leaves to the Judiciary the task of imputing to Congress an undeclared will, **the ambiguity should be resolved in favor of lenity. And this not out of any sentimental consideration, or for want of sympathy with the purpose of Congress in proscribing evil or antisocial conduct. It may fairly be said to be a presupposition of our law to resolve doubts . . . against the imposition of a harsher punishment.**

[Bell v. United States, 349 U.S. 81, 83 (1955)]

U.S. v. Barnes, 222 U.S. 513 (1912)

It is the express extension of those sections to the special taxes imposed by the oleomargarin act which gives rise to the question before stated. **The position taken by the defendants in error, and sustained by the district court, is, that that extension of particular sections is an implied exclusion of all others. Expressio unius est exclusio alterius. [222 U.S. 513, 519] We are unable to assent to that position. The maxim invoked expresses a rule of construction, not of substantive law, and serves only as an aid in discovering the legislative intent when that is not otherwise manifest. In such instances it is of deciding importance; in others, not. In the instance now before us too much is claimed for it.** The sections named in 3 of the oleomargarin act are a part of chapter 3 of title 35 of the Revised Statutes. They relate exclusively to special taxes, and are so restricted in their terms that it is at least doubtful that they could be applied to any special taxes not imposed by that chapter, unless expressly extended to them. To illustrate, 3232, which precedes the others and is more or less a key to their meaning, declares: 'No person shall be engaged in or carry on any trade or business hereinafter mentioned until he has paid a special tax therefor in the manner hereinafter provided.' On the other hand, the sections in chapters 1 and 2 are, with minor exceptions, so general in their terms as to leave no doubt of their applicability to taxes imposed by subsequent legislation containing no provision to the contrary. In other words, the difference between the sections named and those in chapters 1 and 2 discloses an occasion for affirmatively extending the operation of the former, and no occasion for mentioning the latter. It also is apparent that the oleomargarin act will measurably fail of its purpose if the general provisions of chapters 1 and 2 are not applicable to the taxes which it imposes; for, as before indicated, it does not in itself provide a complete or effective scheme for their enforcement. Neither does it contain any provision for the redress of those from whom such taxes are erroneously or illegally exacted, although the settled policy of the government long has been to afford relief from all such exactions, as is shown by 3220, 3226, 3227, and 3228 in chapter 2 (U. S. Comp. Stat. 1901, pp. 2086, 2088, 2089). These omissions are cogent evidence that it is intended that recourse shall be had to the [222 U.S. 513, 520] general provisions of chapters 1 and 2, save as, in the oleomargarin act, it may be provided otherwise.

Much of our national legislation is embodied in codes, or systematic collections of general rules, each dealing in a comprehensive way with some general subject, such as the customs internal revenue, public lands, Indians, and patents for inventions; and it is the settled rule of decision in this court that where there is subsequent legislation upon such a subject, it carries with it an implication that the general rules are not superseded, but are to be applied in its enforcement, save as the contrary clearly appears. Thus, in Wood v. United States, 16 Pet. 342, 363, 10 L. ed. 987, 995, where a question arose as to what effect should be given a general provision of an early customs law in view of a later enactment upon that subject, it was said: 'And it may be added that, in the interpretation of all laws for the collection of revenue, whose provisions are often very complicated and numerous to guard against frauds by importers, it would be a strong ground to assert that the main provisions of any such laws sedulously introduced to meet the case of a palpable fraud should be deemed repealed, merely because in subsequent laws other powers and authorities are given to the customhouse officers, and other modes of proceeding are allowed to be had by them before the goods have passed from their custody, in order to ascertain whether there has been any fraud attempted upon the government. The more natural, if not the necessary, inference in all such cases is, that the legislature intend the new laws to be quxiliary to and in aid of the purposes of the old law, even when some of the cases provided for may equally be within the reach of each. There certainly, under such circumstances, ought to be a manifest and total repugnancy in the provisions to lead to the conclusion that the latter laws abrogated, and were designated to abrogate, the former.' In Saxonville Mills v. Russell, 116 U.S. 13, 21 , 29 S. L. ed. 554, 556, 6 Sup. Ct. Rep. 237, it was said, in disposing of a like [222 U.S. 513, 521] question: 'It would be an unsound and unsafe rule of construction which would separate from the tariff revenue system, consisting of numerous and diverse enactments, each new act altering it, in any of its details, or prescribing new duties in lieu of existing ones on particular articles. The whole system must be regarded in each alteration, and no disturbance allowed of existing legislative rules of general application beyond the clear intention of Congress.' And in Catholic Bishop v. Gibbon, 158 U.S. 155, 166 , 167 S., 39 L. ed. 931, 936, 15 Sup. Ct. Rep. 779, where the question was whether general statutes defining the powers of the officers of the Land Department were applicable to a grant of public lands by a subsequent act of Congress, it was said: 'While there may be no specific reference in the act of 1848 [9 Stat. at L. 323, chap. 177] of questions arising under this grant to the Land Department, yet its administration comes within the scope of the general powers vested in that Department . . . . It may be laid down as a general rule that, in the absence of some specific provision to the contrary in respect to any particular grant of public land, its administration falls wholly and absolutely within the jurisdiction of the Commissioner of the General Land Office, under the supervision of the Secretary of the Interior. It is not necessary that with each grant there shall go a direction that its administration shall be under the authority of the Land Department. It falls there unless there is express direction to the contrary.'

We conclude that, while the express extension of particular sections in chapter 3, dealing with special taxes, to the like taxes imposed by 3 of the oleomargarin act, may operate as an implied exclusion of the other sections in that chapter, it does not in any wise restrict or affect the operation of any of the general sections in chapters 1 and 2. And as 3177 is a part of chapter 2, is general in its terms, and does not appear to be repugnant to any provision in the oleomargarin act, we think the ques- [222 U.S. 513, 522] tion first above stated must be answered in the affirmative.

The cases of Craft v. Schafer, 83 C. C. A. 677, 154 Fed. 1002; Tucker v. Grier, 87 C. C. A. 513, 160 Fed. 611, and Hastings v. Herold, 184 Fed. 759, although not involving 3177, disclose some contrariety of opinion in the lower Federal courts upon the matter principally discussed herein, and we deem it appropriate to observe that our conclusion has been reached only after a careful consideration of those cases.

Neuberger v. Commissioner of Internal Revenue, 311 U.S. 83 (1940)

Sections 181-189 of the Revenue Act of 1932, 47 Stat. 169, 222-223, provide generally for computation and reporting of partnership income. In requiring a partnership informational return although only individual partners pay any tax, Congress recognized the partnership both as a business unit and as an association of individuals. This weakens rather than strengthens respondent's argument that the privileges are distinct or that the unit characteristics of the partnership must be emphasized. Compare Jennings v. Commissioner, 5 Cir., 110 F.2d 945; Craik v. United States, Ct.Cl., 31 F.Supp. 132; United States v. Coulby, D.C., 251 F. 982, affirmed, 6 Cir., 258 F. 27. Nor is the deduction claimed here precluded because Congress, in Sections 184-188, has particularized instances where partnership income retains its identity in the individual partner's return. **The maxim 'expressio unius est exclusio alterius' is an aid to construction not a rule of law. It can never override clear and contrary evidences of Congressional intent. United States v. Barnes, 222 U.S 513, 32 S.Ct. 117.**

It is true that the Treasury Department adopted a contrary position and denied the claimed deduction. G. [311 U.S. 83, 89] C. M. 14012, XIV-1 Cum.Bull. 145; I.T. 2892, XIV-1 Cum.Bull. 148. Under different circumstances great weight has been attached to administrative practice and treasury rulings, but beyond question they cannot narrow the scope of a statute when Congress plainly has intended otherwise. Rasquin v. Humphreys, 308 U.S. 54 , 60 S.Ct. 60; Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294 , 53 S.Ct. 350.

Meese v. Keene, 481 U.S. 465, 484 (1987)

"It is axiomatic that the statutory definition of the term excludes unstated meanings of that term. Colautti v. Franklin, 439 U.S. 379, 392, and n. 10 (1979). Congress' use of the term "propaganda" in this statute, as indeed in other legislation, has no pejorative connotation.{19} **As judges, it is our duty to [481 U.S. 485] construe legislation as it is written, not as it might be read by a layman, or as it might be understood by someone who has not even read it.**" [Meese v. Keene, 481 U.S. 465, 484 (1987)]

Stenberg v. Carhart, 530 U.S. 914 (2000)

"**When a statute includes an explicit definition, we must follow that definition, even if it varies from that term's ordinary meaning.** Meese v. Keene, 481 U.S. 465, 484-485 (1987) ("It is axiomatic that the statutory definition of the term excludes unstated meanings of that term"); Colautti v. Franklin, 439 U.S. at 392-393, n. 10 ("As a rule, `a definition which declares what a term "means" . . . excludes any meaning that is not stated'"); Western Union Telegraph Co. v. Lenroot, 323 U.S. 490, 502 (1945); Fox v. Standard Oil Co. of N.J., 294 U.S. 87, 95-96 (1935) (Cardozo, J.); see also 2A N. Singer, Sutherland on Statutes and Statutory Construction § 47.07, p. 152, and n. 10 (5th ed. 1992) (collecting cases). That is to say, the statute, read "as a whole," post at 998 [530 U.S. 943] (THOMAS, J., dissenting), leads the reader to a definition. That definition does not include the Attorney General's restriction -- "the child up to the head." Its words, "substantial portion," indicate the contrary." [Stenberg v. Carhart, 530 U.S. 914 (2000)]

Colautti v. Franklin, 439 U.S. 379 (1979)

"As a rule, `a definition which declares what a term "means" . . . **excludes** any meaning that is not stated'" [Colautti v. Franklin, 439 U.S. 379 (1979), n. 10]

Scheidler v. National Organization for Women, 537 U.S. 393 (2003)

Absent contrary direction from Congress, we begin our interpretation of statutory language with the general presumption that a statutory term has its common law meaning. See Taylor v. United States, 495 U.S. 575, 592 (1990); Morissette v. United States, 342 U.S. 246, 263 (1952).
[Scheidler v. National Organization for Women, 537 U.S. 393 (2003)]

Fischer v. United States, 529 U.S. 667 (2000)

This expansive construction of § 666(b) is, at the very least, **inconsistent with the rule of lenity -- which the Court does not discuss. This principle requires that, to the extent that there is any ambiguity in the term "benefits," we should resolve that ambiguity in favor of the defendant. See United States v. Bass, 404 U.S. 336, 347 (1971) ("In various ways over the years, we have stated that, when choice has to be made between two readings of what conduct Congress has made a crime, it is appropriate, before we choose the harsher alternative, to require that Congress should have spoken in language that is clear and definite" (internal quotation marks omitted)).**

[Fischer v. United States, 529 U.S. 667 (2000)]

"includes" from Lost Horizons Website: From: http://www.losthorizons.com/comment/The Law Means What It Says.pdf

"Include or the participial form thereof, is defined to comprise within'; 'to hold'; 'to contain'; 'to shut up'; and synonyms

are ‘contain’; ‘enclose’; ‘comprehend’; ‘embrace’.” [U.S. Supreme Court, Montello Salt co. v. Utah, 221 U.S. 452, at 455, 466.]

When pressed, a typical not-worth-his-air tax specialist (read: beneficiary) will try in desperation to deploy section 7701(c) of the code: *“Includes and including: The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.”*

The desired implication to be taken is that terms defined as *“xx includes…”* embrace all things commonly meant by the word being defined plus those things listed after *“includes”*. This feeble effort to muddy the waters quickly fails under even a cursory analysis.

First, if the word being made into a legal term is meant to be understood as having its common meaning, there is no need to define it at all. It is axiomatic that if a word is explicitly defined it has a restricted meaning. If language to the effect of, *“For purposes of this paragraph, the term “Fruit” includes apples, pears, and oranges.”* is offered, it can only be understood as restricting the definition to those things listed, or no definition would have been required; the word *“fruit”* would have been understood to include apples, pears and oranges, as well as all other fruits.

Second, note that the word *"common"* (or its equivalent) is left out of the definition of *"includes"* and *"including"*, creating a sophomoric circular argument. The only *"other things otherwise within the meaning of the term defined"* are those that are the same as those used to provide the definition. In other words, the *"things"* used in the definition are what establish the class to which the *"other things"* must belong in order to be included under the doctrine of 7701(c), and, as the word is being singled out for definition, absent explicit language to the contrary the common meaning of the word must be excluded. To see what I mean, insert the word *"common"* as follows: *"The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise with the common meaning of the term defined."*. Without it, the section is meaningless, but misleading, as intended. Furthermore, note that the statute says, *"...the meaning of the **term** defined."*, rather than the **word** defined. If Congress had meant (and been Constitutionally able) to embrace within its definitions the common meaning of the words being made into legal terms it would have written 7701 (c) in that way: *"The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the word defined."* The word isn't a term until the provided definition has been applied, at which point its common meaning has been stripped away.
If *"Fruit"* is defined thusly: *"When used in this paragraph, the term "Fruit" includes turnips, carrots and broccoli."*, is it to be presumed that it also means apples? How about if in the next paragraph one finds, *"For purposes of this paragraph the term "Fruit" includes apples, turnips, carrots and broccoli."* Should it be presumed that apples was included by implication in the first definition and the writer was just lazy, or ran out of typewriter ribbon? Obviously not.
If the writer had, in the first instance, said, *"For purposes of this paragraph the term "Fruit", in addition to the commonly understood meaning of the word "fruit", includes..."* or, *"..."Fruit", in addition to all fruits, includes..."* or even simply, *"..."Fruit" also includes..."*, all is different. But he did not.

Finally, though it is irrelevant to the logical analysis of the section except insofar as it underscores its meaninglessness, saying that something shall not be deemed to be excluded does not mean that it must or should be deemed to be included, regardless of how it is defined or classified, or whether necessary referents are provided. The very creation of the section reveals an overall intent to dissemble. If Congress had the authority (or simply meant) to enact what they wish us all to believe that they enacted through this clause, it would have read: *“Includes and including: The terms "includes" and "including" when used in a definition contained in this title shall be construed as expanding the class represented by the common meaning of the word defined with the addition of the explicitly listed items.”* But it does not. For that matter, Congress could have simply inserted one simple clause into the code, in one place only, to the effect of, *"Public sector workers, officials and organizations are to be considered subject to the requirements of this title in the same fashion as are private citizens and organizations"*. That it did not must be given proper significance.
As the United States Supreme Court observed,
"The construction of a statute by those charged with its execution should be followed unless there are compelling

indications that it is wrong, especially when Congress has refused to alter the administrative construction, and such deference is particularly appropriate where an agency's interpretation involves issues of considerable public controversy and Congress has not acted to correct any misperception of its statutory objectives." CBS, INC. v FCC, 453 US 367, p. 367, 69 L Ed 2d 706, p. 709 190155/564515

This language has been on the books for 64 years and Congress has revised the code a few hundred times during that period. The IRS has floated a ridiculous "explanation" to the effect that the use of *"includes"* is because of doubts at one time as to whether the public sector was covered by the IRC. This proposition might have a little hang time if the relevant references were found in an addendum or supplement, but not when they constitute the sole definition of the term. There is no other list to which the public-sector references can be added; they ARE the list. This doesn't stop your average tax "professional" from parroting the nonsense, of course.

The simple tawdry fact is that Congress wants to spend lots of your money, and even though it can't seize it from you legally, they are perfectly willing to set up a system by which you are led to believe that they can, and about which you will have great difficulty discovering the truth. Dwell on this a while and the nuances of the phrase 'voluntary compliance' will suddenly become clear. What it refers to is you "voluntarily" allowing yourself to be characterized as a public-sector beneficiary, and then complying with requirements that attach to that status.

Click here to read Congresswoman Barbara Kennelly's reply to a constituent on this subject.

- The United States Supreme Court: *"This fact only underscores our duty to refrain from reading a phrase into the statute when Congress has left it out. " '[W]here Congress includes particular language in one section of a statute but omits it in another ..., it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.' "* Russello v United States, 464 US 16, 23, 78 L Ed 2d 17, 104 S Ct. 296 (1983)

Definitions in the U.S code which *are not* relied upon to establish whether you received taxable "wages":

- Title 26 Subtitle C, Chapter 21, Subchapter C, Section 3121: (FICA Income Tax-- application of this tax is based upon citizenship and residency, not being an "employee" as such)
  Employee
  For purposes of this chapter, the term "employee" means -
  (1) any officer of a corporation; or
  (2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee;
- Title 26, Subtitle D, Chapter 38, Subchapter A, Sec. 4612. (Petroleum Tax)
  (4) United States
  In general
  The term "United States" means the 50 States, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands.
- Title 20, Chapter 69, Section 6103 (Education)
  As used in this chapter:
  (8) Employer- The term "employer" includes both public and private employers.

Other relevant Supreme Court rulings:

- *"When the words of a statute are unambiguous, the first canon of statutory construction--that courts must presume that a legislature says in a statute what it means and means in a statute what it says there--is also the last, and judicial inquiry is complete."* Connecticut National Bank v. Germain, 503 US 249 (1992)

- *"As in all cases involving statutory construction, "our starting point must be the language employed by Congress," Reiter v Sonotone Corp., 442 US 330, 337, 60 L Ed 2d 931, 99 S Ct. 2326 (1979), and we assume that the legislative purpose is expressed by the ordinary meaning of the words used."* Richards v United States, 369 US 1, 9, 7 L Ed 2d 492, 82 S Ct.

585 (1962)

- *"When the terms of a statute are unambiguous, judicial inquiry is complete except in rare and exceptional circumstances."* FREYTAG v. COMMISSIONER, 501 US 868 (1991), 115 L Ed 2d 764, pp. 767
- *"In a statutory construction case, the beginning point must be the language of the statute, and when a statute speaks with clarity to an issue, judicial inquiry into the statute's meaning--in all but the most extraordinary circumstance--is finished; courts must give effect to the clear meaning of statutes as written."* Estate of Cowart v. Nicklos Drilling Co., 505 US 469, 120 L Ed 2d 379, 112 S Ct. 2589 (1992)
- *"It is not a function of the United States Supreme Court to sit as a super-legislature and create statutory distinctions where none were intended."* AMERICAN TOBACCO CO. v PATTERSON, 456 US 63, 71 L Ed 2d 748, 102 S Ct. 1534
- *"The United States Supreme Court cannot supply what Congress has studiously omitted in a statute."* FEDERAL TRADE COM. v SIMPLICITY PATTERN CO., 360 US 55, p. 55, 475042/56451
- *"The starting point in any endeavor to construe a Statute is always the words of the Statute itself; unless Congress has clearly indicated that its intentions are contrary to the words it employed in the Statute, this is the ending point of interpretation."* Fuller v. United States 615 F. Supp. 1054 (D.C. Cal 1985) , West's Key 188 quoting Richards v. United States, 369 US 1, 9, 82 S. Ct. 585, 590, 7 L.Ed. 2d 492 (1962)
- *"The starting point for interpreting a statute is the language of the statute itself; absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive."* PRODUCT SAFETY COMM'N v. GTE SYLVANIA, 447 US 102, 64 L Ed 2d 766, 100 S Ct. 2051 (1980)
- *"Words used in the statute are to be given their proper signification and effect."* Washington Market Co. v. Hoffman, 101 U. S. 112, 115, 25 L. Ed. 782, 783 (1879).

CITES BY TOPIC: public office

Public Office, pursuant to Black's Law Dictionary, Abridged 6th Edition, means:

"Essential characteristics of a '**public office**' are:
(1) Authority conferred by law,
(2) Fixed tenure of office, and
(3) Power to exercise some of the sovereign functions **of government**.
(4) Key element of such test is that "officer is carrying out a sovereign function'.
(5) Essential elements to establish public position as 'public office' are:
(a) Position must be created by Constitution, legislature, or through authority conferred by legislature.
(b) Portion of sovereign power of government must be delegated to position,
(c) Duties and powers must be defined, directly or implied, by legislature or through legislative authority.
(d) Duties must be performed independently without control of superior power other than law, and
(e) Position must have some permanency."

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26 CFR §1.1402(c)-2: Public Office

Title 26: Internal Revenue
PART 1—INCOME TAXES
TAX ON SELF-EMPLOYMENT INCOME

§ 1.1402(c)-2 Public office.

(a) *In general*—(1) *General rule.* Except as otherwise provided in subparagraph (2) of this paragraph, the performance of the functions of a public office does not constitute a trade or business.

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28 U.S.C. §201 Bribery of public officials and witnesses

TITLE 18 > PART I > CHAPTER 11 > § 201
§ 201. Bribery of public officials and witnesses

(a) For the purpose of this section—

(1) the term "public official" means Member of Congress, Delegate, or Resident Commissioner, either before or after such official has qualified, or an officer or employee or person acting for or on behalf of the United States, or any department, agency or branch of Government thereof, including the District of Columbia, in any official function, under or by authority of any such department, agency, or branch of Government, **or a juror**

Osborn v. Bank of U.S., 22 U.S. 738 (1824)

*"**All the powers of the government must be carried into operation by individual agency, either through the medium of public officers, or contracts made with individuals.** Can any public office be created, or does one exist, the performance*

of which may, with propriety, be assigned to this ***association [or trust], when incorporated? If such office exist, or can be created, then the company may be incorporated, that they may be appointed to execute such office. Is there any portion of the public business performed by individuals upon contracts, that this association could be employed to perform, with greater advantage and more safety to the public, than an individual contractor? If there be an employment of this nature, then may this company be incorporated to undertake it.***

There is an employment of this nature. *Nothing can be more essential to the fiscal concerns of the nation, than an agent of undoubted integrity and established credit, with whom the public moneys can, at all times, be safely deposited. Nothing can be of more importance to a government, than that there should be some capitalist in the country, who possesses the means of making advances of money to the government upon any exigency, and who is under a legal obligation to make such advances. For these purposes the association would be an agent peculiarly suitable and appropriate. [. . .]*

The mere creation of a corporation, does not confer political power or political character. So this Court decided in Dartmouth College v. Woodward, already referred to. If I may be allowed to paraphrase the language of the Chief Justice, I would say, a bank incorporated, is no more a State instrument, than a natural person performing the same business would be. If, then, a natural person, engaged in the trade of banking, should contract with the government to receive the public money upon deposit, to transmit it from place to place, without charging for commission or difference of exchange, and to perform, when called upon, the duties of commissioner of loans, would not thereby become a public officer, how is it that this artificial being, created by law for the purpose of being employed by the government for the same purposes, should become a part of the civil government of the country? Is it because its existence, its capacities, its powers, are given by law? because the government has given it power to take and hold property in a particular form, and to employ that property for particular purposes, and in the disposition of it to use a particular name? because the government has sold it a privilege [22 U.S. 738, 774] for a large sum of money, and has bargained with it to do certain things; is it, therefore, a part of the very government with which the contract is made?

If the Bank be constituted a public office, by the connexion between it and the government, it cannot be the mere legal franchise in which the office is vested; the individual stockholders must be the officers. *Their character is not merged in the charter. This is the strong point of the Mayor and Commonalty v. Wood, upon which this Court ground their decision in the Bank v. Deveaux, and from which they say, that cause could not be distinguished. Thus, aliens may become public officers, and public duties are confided to those who owe no allegiance to the government, and who are even beyond its territorial limits.*

With the privileges and perquisites of office, all individuals holding offices, ought to be subject to the disabilities of office. But if the Bank be a public office, and the individual stockholders public officers, this principle does not have a fair and just operation. *The disabilities of office do not attach to the stockholders; for we find them every where holding public offices, even in the national Legislature, from which, if they be public officers, they are excluded by the constitution in express terms.*

If the Bank be a public institution of such character as to be justly assimilated to the mint and the post office, then its charter may be amended, altered, or even abolished, at the discretion of the National Legislature. All public offices are created [22 U.S. 738, 775] purely for public purposes, and may, at any time, be modified in such manner as the public interest may require. Public corporations partake of the same character. So it is distinctly adjudged in Dartmouth College v. Woodward. In this point, each Judge who delivered an opinion concurred. By one of the Judges it is said, that '*public corporations are generally esteemed such as exist for public political purposes only, such as towns, cities, parishes and counties; and in many respects they are so, although they involve some private interests; but, strictly speaking, public corporations are such only as are founded by the government for public purposes, where the whole interest belongs also to the government.* ***If, therefore, the foundation be private, though under the charter of the government, the corporation is private, however extensive the uses may be to which it is devoted, either by the bounty of the founder, or the nature and objects of the institution. For instance, a bank, created by the government for its own***

uses, whose stock is exclusively owned by the government, is, in the strictest sense, a public corporation. So, a hospital created and endowed by the government for general charity. But a bank, whose stock is owned by private persons, is a private corporation, although it is erected by the government, and its objects and operations partake of a public nature. The same doctrine may be affirmed of insurance, canal, bridge, and turnpike companies. In all these cases, the uses may, in a certain sense, be called public, *but the corporations are private; as much [22 U.S. 738, 776] so, indeed, as if the franchises were vested* ***in a single person.[. . .]***

In what sense is it an instrument of the government? and in what character is it employed as such? Do the government employ the faculty, the legal franchise, or do they employ the individuals upon whom it is conferred? and what is the nature of that employment? does it resemble the post office, or the mint, or the custom house, or the process of the federal Courts?

The post office is established by the general government. It is a public institution. The persons who perform its duties are public officers. No individual has, or can acquire, any property in it. For all the services performed, a compensation is paid out of the national treasury; and all the money received upon account of its operations, is public property. Surely there is no similitude between this institution, and an association who trade upon their own capital, for their own profit, and who have paid the government a million and a half of dollars for a legal character and name, in which to conduct their trade.

Again: the business conducted through the agency of the post office, is not in its nature a private business. It is of a public character, and the [22 U.S. 738, 786] charge of it is expressly conferred upon Congress by the constitution. The business is created by law, and is annihilated when the law is repealed. But the trade of banking is strictly a private concern. It exists and can be carried on without the aid of the national Legislature. Nay, it is only under very special circumstances, that the national Legislature can so far interfere with it, as to facilitate its operations.

The post office executes the various duties assigned to it, by means of subordinate agents. The mails are opened and closed by persons invested with the character of public officers. But they are transported by individuals employed for that purpose, in their individual character, which employment is created by and founded in contract. To such contractors no official character is attached. These contractors supply horses, carriages, and whatever else is necessary for the transportation of the mails, upon their own account. The whole is engaged in the public service. The contractor, his horses, his carriage, his driver, are all in public employ. But this does not change their character. All that was private property before the contract was made, and before they were engaged in public employ, remain private property still. The horses and the carriages are liable to be taxed as other property, for every purpose for which property of the same character is taxed in the place where they are employed. The reason is plain: the contractor is employing his own means to promote his own private profit, and the tax collected is from the individual, though assessed upon the [22 U.S. 738, 787] means he uses to perform the public service. To tax the transportation of the mails, as such, would be taxing the operations of the government, which could not be allowed. But to tax the means by which this transportation is effected, so far as those means are private property, is allowable; because it abstracts nothing from the government; and because, the fact that an individual employs his private means in the service of the government, attaches to them no ***immunity whatever."***

[Osborn v. Bank of U.S., 22 U.S. 738 (1824)]

McNally v. United States, 483 U.S. 350 (1987)

Fraud in its elementary common law sense of deceit -- and this is one of the meanings that fraud bears [483 U.S. 372] in the statute, see United States v. Dial, 757 F.2d 163, 168 (7th Cir.1985) -- includes the deliberate concealment of material information in a setting of fiduciary obligation. **A public official is a fiduciary toward the public, including, in**

the case of a judge, the litigants who appear before him, and if he deliberately conceals material information from them, he is guilty of fraud. When a judge is busily soliciting loans from counsel to one party, and not telling the opposing counsel (let alone the public), he is concealing material information in violation of his fiduciary obligations.

* * * *

Second, the systematic and long-continued receipt of bribes by a public official, coupled with active efforts to conceal the bribe-taking from the public and the authorities . . . is fraud (again in its elementary sense of deceit, and quite possibly in other senses as well), even if it is the public, rather than counsel, that is being kept in the dark. It is irrelevant that, so far as appears, Holzer never ruled differently in a case because of a lawyer's willingness or unwillingness to make him a loan, so that his conduct caused no demonstrable loss either to a litigant or to the public at large. See, e.g., United States v. Keane, 622 F.2d 534, 541, 546 (7th Cir.1975); United States v. Lovett, 811 F.2d 979, 985 (7th Cir.1987); United States v. Manton, 107 F.2d 834, 846 (2d Cir.1939). How can anyone prove how a judge would have ruled if he had not been bribed?

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PART VI—PARTICULAR PROCEEDINGS

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SUBCHAPTER A—DEFINITIONS AND GENERAL PROVISIONS

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§ 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).

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(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.

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TITLE 26 > Subtitle F

Subtitle F—Procedure and Administration

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§ 6671. Rules for application of assessable penalties

(a) Penalty assessed as tax

The penalties and liabilities provided by this subchapter shall be paid upon notice and demand by the Secretary, and shall be assessed and collected in the same manner as taxes. Except as otherwise provided, any reference in this title to "tax" imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter.

(b) Person defined

The term "person", as used in this subchapter, includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

TITLE 26 > Subtitle F > CHAPTER 75

CHAPTER 75—CRIMES, OTHER OFFENSES, AND FORFEITURES

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Subchapter D—Miscellaneous Penalty and Forfeiture Provisions

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§ 7343. Definition of term “person”

How Current is This?

The term “person” as used in this chapter includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

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objects are fiscal; protective if designed to relieve domestic businesses from effective foreign competition; discriminatory if they apply unequally to products of different countries; and retaliatory if they are designed to compel a country to remove artificial trade barriers against the entry of another nation's products.

A public document setting forth services of common carrier being offered, rates and charges with respect to services and governing rules, regulations and practices relating to those services. International Tel. & Tel. Corp. v. United Tel. Co. of Florida, D.C.Fla., 433 F.Supp. 352, 357.

See also Customs duties; GATT; Most favored nation clause.

Antidumping tariff. A tariff calculated to prevent the dumping or unloading of imported goods below cost by fixing the tariff at the difference between the price at which the goods commonly sell in the country of origin and the price at which it is to be sold in the importing country. *See also* Dumping Act.

Autonomous tariff. Tariff set by legislation and not by commercial treaties.

Joint tariff. Schedule of rates established by two or more carriers covering shipments between places requiring the use of facilities owned by such carriers.

Preferential tariff. Tariff aimed at favoring the products of one country over those of another. *See also* Most favored nation clause; Preferential tariff.

Protective tariff. Tariff designed to protect or encourage domestic goods by imposing a high rate on imported goods of a similar nature. *See also* Protective tariff.

Revenue tariff. Tariff designed primarily to raise revenues and to support the customs service instead of encouraging production of imported goods.

Tath /táθ/téyθ/. In the counties of Norfolk and Suffolk, the lords of manors anciently claimed the privilege of having their tenants' flocks or sheep brought at night upon their own demesne lands, there to be folded for the improvement of the ground, which liberty was called by the name of the "tath."

Tauri liberi libertas /tóhray líbəray ləbártæs/°líbərtæs/. Lat. A common bull; because he was free to all the tenants within such a manor, liberty, etc.

Tautology /totóləjiy/. Describing the same thing twice in one sentence in equivalent terms; a fault in rhetoric. It differs from repetition or iteration, which is repeating the same sentence in the same or equivalent terms; the latter is *sometimes* either excusable or necessary in an argument or address; the former (tautology) never.

Taverner. In old English law, a seller of wine; one who kept a house or shop for the sale of wine.

Tavern keeper. One who owns and operates a tavern or an inn.

Tax. A charge by the government on the income of an individual, corporation, or trust, as well as the value of an estate or gift. The objective in assessing the tax is to generate revenue to be used for the needs of the public.

A pecuniary burden laid upon individuals or property to support the government, and is a payment exacted by legislative authority. In re Mytinger, D.C.Tex., 31 F.Supp. 977, 978, 979. Essential characteristics of a tax are that it is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority. Michigan Employment Sec. Commission v. Patt, 4 Mich.App. 228, 144 N.W.2d 663, 665. Annual compensation paid to government for annual protection and for current support of government. Alabama Power Co. v. Federal Power Commission, C.C.A.5, 134 F.2d 602, 608. A ratable portion of the produce of the property and labor of the individual citizens, taken by the nation, in the exercise of its sovereign rights, for the support of government, for the administration of the laws, and as the means for continuing in operation the various legitimate functions of the state. An enforced contribution of money or other property, assessed in accordance with some reasonable rule or apportionment by authority of a sovereign state on persons or property within its jurisdiction for the purpose of defraying the public expenses.

In a general sense, any contribution imposed by government upon individuals, for the use and service of the state, whether under the name of toll, tribute, tallage, gabel, impost, duty, custom, excise, subsidy, aid, supply, or other name. And in its essential characteristics is not a debt. City of Newark v. Jos. Hollander, Inc., 136 N.J.Eq. 539, 42 A.2d 872, 875.

See also Accumulated earnings tax; Estate tax; Estimated tax; Excess profits tax; Excise tax; Gift tax; Holding company tax; Income tax; Inheritance tax; Intangibles tax; Investment tax credit; Levy; License fee *or* tax; Occupation tax; Payroll tax; Poll-tax; Progressive tax; Property tax; Regressive tax; Sales tax; Service occupation tax; Surtax; Taxation; Toll; Transfer tax; Undistributed profits tax; Use tax; Withholding.

Synonyms

In a broad sense, *taxes* undoubtedly include *assessments,* and the right to impose assessments has its foundation in the taxing power of the government; and yet, in practice and as generally understood, there is a broad distinction between the two terms. "Taxes," as the term is generally used, are public burdens imposed generally upon the inhabitants of the whole state, or upon some civil division thereof, for governmental purposes, without reference to peculiar benefits to particular individuals or property. "Assessments" have reference to impositions for improvements which are specially beneficial to particular individuals or property, and which are imposed in proportion to the particular benefits supposed to be conferred. They are justified only because the improvements confer special benefits, and are just only when they are divided in proportion to such benefits. As distinguished from other kinds of taxation, "assessments" are those special and local im-

The owner or proprietor of a thing, as distinguished from him who uses it merely. A master or principal, as distinguished from an agent or attorney.

In the civil law, a husband; a family.

Dominus capitalis loco hæredis habetur, quoties per defectum vel delictum extinguitur sanguis sui tenentis /dómənəs kæ̀pətéyləs lówkow həríydəs həbíytər, kwówshiyiyz pə̀r dəféktəm vèl dəlíktəm ekstíŋgwətər sǽŋgwəs s(y)úway tənéntəs/. The supreme lord takes the place of the heir, as often as the blood of the tenant is extinct through deficiency or crime.

Dominus litis /dómənəs láytəs/. Lat. The master of the suit; *i.e.*, the person who was really and directly interested in the suit as a party, as distinguished from his attorney or advocate. But the term is also applied to one who, though not originally a party, has made himself such, by intervention or otherwise, and has assumed entire control and responsibility for one side, and is treated by the court as liable for costs. Virginia Electric & Power Co. v. Bowers, 181 Va. 542, 25 S.E.2d 361, 363.

Dominus navis /dómənəs néyvəs/. In the civil law, the owner of a vessel.

Dominus non maritabit pupillum nisi semel /dómənəs nòn mærətéybət pyuwpíləm náysay séməl/. A lord cannot give a ward in marriage but once.

Dominus rex nullum habere potest parem, multo minus superiorem /dómənəs réks nələm həbíriy pówtəst pǽrəm, məltow máynəs səpìriyórəm/. The king cannot have an equal, much less a superior.

Domitæ /dómətiy/. Lat. Tame; domesticated; not wild. Applied to domestic animals, in which a man may have an absolute property. 2 Bl.Comm. 391.

Dommages intérêts. In French law, damages.

Domo reparanda /dówmow rèpərǽndə/. A writ that lay for one against his neighbor, by the anticipated fall of whose house he feared a damage and injury to his own.

Dom. Proc. An abbreviation of *Domus Procerum* or *Domo Procerum;* the house of lords in England. Sometimes expressed by the letters D. P.

Domus /dówməs/. Lat. In the civil and old English law, a house or dwelling; a habitation. Shreveport Long Leaf Lumber Co. v. Wilson, D.C.La., 38 F.Supp. 629, 631. *See* Domicile.

Domus conversorum /dówməs kònvərsórəm/. An ancient house built or appointed by King Henry III for such Jews as were converted to the Christian faith; but King Edward III, who expelled the Jews from the kingdom, deputed the place for the custody of the rolls and records of the chancery.

Domus dei /dówməs díyay/. The house of God; a name applied to many hospitals and religious houses.

Domus procerum /dó(w)məs pró(w)sərəm/. The house of lords, abbreviated into *Dom. Proc.,* or *D. P.*

Domus sua cuique est tutissimum refugium /dówməs s(y)úwə k(yu)wáykwiy èst tyuwtísəməm rəfyúwjiyəm/. To every man his own house is his safest refuge. The house of every one is to him as his castle and fortress, as well for his defense against injury and violence as for his repose. A man's dwellinghouse is his castle, not for his own personal protection merely, but also for the protection of his family and his property therein.

Domus tutissimum cuique refugium atque receptaculum sit /dówməs tyuwtísəməm k(yu)wáykwiy rəfyúwjiyəm ǽtkwiy rəsèptǽkyələm sít/. A man's house should be his safest refuge and shelter. The habitation of each one is an inviolable asylum for him. A maxim of the Roman law.

Dona clandestina sunt semper suspiciosa /dównə klæ̀ndəstáynə sənt sémpər səspìshiyówsə/. Clandestine gifts are always suspicious.

Donari videtur, quod nullo jure cogente conceditur /dòwnéray vədíytər kwòd nəlow júriy kəjéntiy kənsíydətər/. A thing is said to be given when it is yielded otherwise than by virtue of right (that is considered to be given which is granted when no law compels).

Donatarius /dòwnətériyəs/. A donee; one to whom something is given. *See* Donee.

Donated stock. Securities given to a corporation by its own stockholders commonly for resale.

Donated surplus. Contribution of assets to a corporation generally in the form of stock from its stockholders.

Donatio /dòwnéysh(iy)ow/. Lat. A gift. A transfer of the title to property to one who receives it without paying for it. The act by which the owner of a thing voluntarily transfers the title and possession of the same from himself to another person, without any consideration.

By the civil law (adopted into the English and American law) donations are either *inter vivos* (between living persons) or *mortis causa* (in anticipation of death). As to these forms, see *infra.* A *donatio* or gift as between living persons is called *donatio mera* or *pura* when it is a simple gift without compulsion or consideration, that is, resting solely on the generosity of the donor, as in the case of most charitable gifts. It is called *donatio remuneratoria* when given as a reward for past services, but still not under any legal compulsion, as in the case of pensions and land-grants. It is called *donatio sub modo* (or *modalis*) when given for the attainment of some special object or on condition that the donee shall do something not specially for the benefit of the donor, as in the case of the endowment of hospitals, colleges, etc., coupled with the condition that they shall be established and maintained. The following terms are also used: *Donatio conditionalis,* a conditional gift; *donatio relata,* a gift made with reference to some service already done, *donatio stricta et coarctura,* a restricted gift, as an estate tail.

INTERNAL REVENUE INVESTIGATION

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

EIGHTY-THIRD CONGRESS

FIRST SESSION

ON

ADMINISTRATION OF THE INTERNAL REVENUE LAWS

PART A

FEBRUARY 3, 4, 5, 6, 9, 10, 25, 26, 27, MARCH 2, 3, 4, 5, 6, 10, 11, 12, AND 13, 1953

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One of my assistants refers to policy and personnel, and of course, under this new structure, we are concerned here in Washington, as I pointed out, largely with policy and in administering the industry, rather than directing the personnel. That is left primarily to the district commissioners or, rather, the assistant district commissioners.

Mr. CURTIS. An alcohol tax matter that would go to the Appeals Section——

Mr. AVIS. There is just no such thing. That is where this structure differs.

Let me point this out now: Your income tax is 100 percent voluntary tax, and your liquor tax is 100 percent enforced tax. Now, the situation is as different as day and night. Consequently, your same rules just will not apply, and therefore the alcohol and tobacco tax has been handled here in this reorganization a little differently, because of the very nature of it, than the rest of the over-all tax problem.

Mr. CURTIS. In other words, the alcohol and tobacco tax setup, while it is a part of the Bureau generally, has more or less an autonomy of its own, with the power and authority vested in it; is that right?

Mr. AVIS. I think that is a fair statement; yes, sir, Mr. Curtis.

Chairman KEAN. How about legal matters; does the counsel of the Bureau advise with you?

Mr. AVIS. Well, we have an Alcohol and Tobacco Tax Division counsel, and he reports to the Chief Counsel of the Bureau, and he is part of the general counsel's setup in the Treasury. But for convenience, so that when I get a problem, for example, over the telephone and it is a question of whether a big factory or a plant's operations are to be set up, I can grab my lawyer across the hall and find out what the law is, don't you see; and he, for convenience, is located right in the adjoining suite to me here in Washington. And the same thing applies in the field. In other words, it is a specialized field, and the lawyers that service alcohol tax are generally attached to the assistant district commissioner's office, as far as space is concerned. They still report to their boss, who is the divisional counsel.

Chairman KEAN. There is a lawyer in every one of the 17 areas?

Mr. AVIS. Yes.

Chairman KEAN. He is under the lawyer who deals with you, who is under the man in Mr. Davis' office at the moment, who is under the man in the Treasury Department?

Mr. AVIS. That is Mr. Tuttle; I think he is the new man.

Mr. CURTIS. But your lawyers are confined to problems relating to alcohol tax and tobacco tax?

Mr. AVIS. Yes; because it is so highly specialized, sir.

Mr. Chairman, I think we have covered the rest of my statement, but I will read it.

The reorganization plan abolished the district supervisors and established in their place 17 assistant district commissioners, Alcohol and Tobacco Tax Division, who, subject to the general supervision of the district commissioners, have substantially the same functions, powers, and duties that the former district supervisors had. All tax and regulatory field functions, including the servicing of the industries,

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Government Spying

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To borrow Money on the credit of the United States;

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;

To provide for the Punishment of counterfeiting the Securities and current Coin of the United States;

To establish Post Offices and post Roads;

To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries;

To constitute Tribunals inferior to the supreme Court;

To define and punish Piracies and Felonies committed on the high Seas, and Offences against the Law of Nations;

To declare War, grant Letters of Marque and Reprisal, and make Rules concerning Captures on Land and Water;

To raise and support Armies, but no Appropriation of Money to that Use shall be for a longer Term than two Years;

To provide and maintain a Navy;

To make Rules for the Government and Regulation of the land and naval Forces;

To provide for calling forth the Militia to execute the Laws of the Union, suppress Insurrections and repel Invasions;

To provide for organizing, arming, and disciplining, the Militia, and for governing such Part of them as may be employed in the Service of the United States, reserving to the States respectively, the Appointment of the Officers, and the Authority of training the Militia according to the discipline prescribed by Congress;

To exercise exclusive Legislation in all Cases whatsoever, over such District (not exceeding ten Miles square) as may, by Cession of Particular States, and the Acceptance of Congress, become the Seat of the Government of the United States, and to exercise like Authority over all Places purchased by the Consent of the Legislature of the State in which the Same shall be, for the Erection of Forts, Magazines, Arsenals, dock-Yards and other needful Buildings;--And

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

Section 9.

The Migration or Importation of such Persons as any of the States now existing shall think proper to admit, shall not be prohibited by the Congress prior to the Year one thousand eight hundred and eight, but a Tax or duty may be imposed on such Importation, not exceeding ten dollars for each Person.

The Privilege of the Writ of Habeas Corpus shall not be suspended, unless when in Cases of Rebellion or Invasion the public Safety may require it.

No Bill of Attainder or ex post facto Law shall be passed.

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census of Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

No Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another: nor shall Vessels bound to, or from, one State, be obliged to enter, clear or pay Duties in another.

No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.

No Title of Nobility shall be granted by the United States: And no Person holding any Office of Profit or Trust under them, shall, without the Consent of the Congress, accept of any present, Emolument, Office, or Title, of any kind whatever, from any King, Prince or foreign State.

Section 10.

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Controul of the Congress.

No State shall, without the Consent of Congress, lay any Duty of Tonnage, keep Troops, or Ships of War in time of Peace, enter into any Agreement or Compact with another State, or with a foreign Power, or engage in War, unless actually invaded, or in such imminent Danger as will not admit of delay.

Annotations

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To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;

To provide for the Punishment of counterfeiting the Securities and current Coin of the United States;

To establish Post Offices and post Roads;

To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries;

To constitute Tribunals inferior to the supreme Court;

To define and punish Piracies and Felonies committed on the high Seas, and Offences against the Law of Nations;

To declare War, grant Letters of Marque and Reprisal, and make Rules concerning Captures on Land and Water;

To raise and support Armies, but no Appropriation of Money to that Use shall be for a longer Term than two Years;

To provide and maintain a Navy;

To make Rules for the Government and Regulation of the land and naval Forces;

To provide for calling forth the Militia to execute the Laws of the Union, suppress Insurrections and repel Invasions;

To provide for organizing, arming, and disciplining, the Militia, and for governing such Part of them as may be employed in the Service of the United States, reserving to the States respectively, the Appointment of the Officers, and the Authority of training the Militia according to the discipline prescribed by Congress;

To exercise exclusive Legislation in all Cases whatsoever, over such District (not exceeding ten Miles square) as may, by Cession of Particular States, and the Acceptance of Congress, become the Seat of the Government of the United States, and to exercise like Authority over all Places purchased by the Consent of the Legislature of the State in which the Same shall be, for the Erection of Forts, Magazines, Arsenals, dock-Yards and other needful Buildings;--And

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

Section 9.

The Migration or Importation of such Persons as any of the States now existing shall think proper to admit, shall not be prohibited by the Congress prior to the Year one thousand eight hundred and eight, but a Tax or duty may be imposed on such Importation, not exceeding ten dollars for each Person.

The Privilege of the Writ of Habeas Corpus shall not be suspended, unless when in Cases or Rebellion or Invasion the public Safety may require it.

No Bill of Attainder or ex post facto Law shall be passed.

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census of Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

No Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another: nor shall Vessels bound to, or from, one State, be obliged to enter, clear or pay Duties in another.

No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.

No Title of Nobility shall be granted by the United States: And no Person holding any Office of Profit or Trust under them, shall, without the Consent of the Congress, accept of any present, Emolument, Office, or Title, of any kind whatever, from any King, Prince or foreign State.

Section 10.

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing it's inspection Laws: and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Controul of the Congress.

No State shall, without the Consent of Congress, lay any Duty of Tonnage, keep Troops, or Ships of War in time of Peace, enter into any Agreement or Compact with another State, or with a foreign Power, or engage in War, unless actually invaded, or in such imminent Danger as will not admit of delay.

Annotations

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Section 7701. Definitions

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof -

(1) Person

The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(2) Partnership and partner

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) Corporation

The term "corporation" includes associations, joint-stock companies, and insurance companies.

(4) Domestic

The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

(5) Foreign

The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) Fiduciary

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) Stock

The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) Shareholder

The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

(9) United States

The term "United States" when used in a geographical sense includes only the States and the District of Columbia.

(10) State

The term "State" shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) Secretary of the Treasury and Secretary

(A) Secretary of the Treasury

Related Resources

Tax Law Guide

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The term "Secretary of the Treasury" means the Secretary of the Treasury, personally, and shall not include any delegate of his.

(B) Secretary

The term "Secretary" means the Secretary of the Treasury or his delegate.

(12) Delegate

(A) In general

The term "or his delegate" -

(i) when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context; and

(ii) when used with reference to any other official of the United States, shall be similarly construed.

(B) Performance of certain functions in Guam or American Samoa

The term "delegate," in relation to the performance of functions in Guam or American Samoa with respect to the taxes imposed by chapters 1, 2, and 21, also includes any officer or employee of any other department or agency of the United States, or of any possession thereof, duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform such functions.

(13) Commissioner

The term "Commissioner" means the Commissioner of Internal Revenue.

(14) Taxpayer

The term "taxpayer" means any person subject to any internal revenue tax.

(15) Military or naval forces and armed forces of the United States

The term "military or naval forces of the United States" and the term "Armed Forces of the United States" each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

(16) Withholding agent

The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

(17) Husband and wife

As used in sections 152(b)(4), 682, and 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term "wife" shall be read "former wife" and the term "husband" shall be read "former husband"; and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term "husband" shall be read "wife" and the term "wife" shall be read "husband."

(18) International organization

The term "international organization" means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288-288f).

(19) Domestic building and loan association

The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association -

(A) which either (i) is an insured institution within the meaning of section 401(a) (!1) of the National Housing Act (12 U.S.C., sec. 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of -

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, and any regular interest in a FASIT, but only in the proportion which the assets of such REMIC or FASIT consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC or FASIT are assets described in clauses (i) through (x), the entire interest in the REMIC or FASIT shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of clause (xi).

(20) Employee

For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104, 105, and 106 with respect to accident and health insurance or accident and health plans, and for the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, and for purposes of applying section 125 with respect to cafeteria plans, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of chapter 21, or in the case of services performed before January 1, 1951, who would be considered an employee if his services were performed during 1951.

(21) Levy

The term "levy" includes the power of distraint and seizure by any means.

(22) Attorney General

The term "Attorney General" means the Attorney General of the United States.

(23) Taxable year

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary, the period for which such return is made.

(24) Fiscal year

The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

(25) Paid or incurred, paid or accrued

The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.

(26) Trade or business

The term "trade or business" includes the performance of the functions of a public office.

(27) Tax Court

The term "Tax Court" means the United States Tax Court.

(28) Other terms

Any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as in such provisions.

(29) Internal Revenue Code

The term "Internal Revenue Code of 1986" means this title, and the term "Internal Revenue Code of 1939" means the Internal Revenue Code enacted February 10, 1939, as amended.

(30) United States person

The term "United States person" means -

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and

(E) any trust if -

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

(31) Foreign estate or trust

(A) Foreign estate

The term "foreign estate" means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

(B) Foreign trust

The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).

(32) Cooperative bank

The term "cooperative bank" means an institution without capital stock organized and operated for mutual purposes and without profit, which -

(A) either -

(i) is an insured institution within the meaning of section 401(a) (!2) of the National Housing Act (12 U.S.C., sec. 1724(a)), or

(ii) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B) and (C) of paragraph (19) of this subsection (relating to definition of domestic building and loan association).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution.

(33) Regulated public utility

The term "regulated public utility" means -

(A) A corporation engaged in the furnishing or sale of -

(i) electric energy, gas, water, or sewerage disposal services, or

(ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) transportation (not included in clause (ii)) by motor vehicle -

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Surface Transportation Board, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Secretary of Transportation.

(F) A corporation engaged in the furnishing or sale of transportation by a water carrier subject to jurisdiction under subchapter II of chapter 135 of title 49.

(G) A rail carrier subject to part A of subtitle IV of title 49, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before

January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

(H) A common parent corporation which is a common carrier by railroad subject to part A of subtitle IV of title 49 if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

The term "regulated public utility" does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F), inclusive. If the taxpayer establishes to the satisfaction of the Secretary that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D).

[(34) Repealed. Pub. L. 98-369, div. A, title IV, Sec. 4112(b)(11), July 18, 1984, 98 Stat. 792]

(35) Enrolled actuary

The term "enrolled actuary" means a person who is enrolled by the Joint Board for the Enrollment of Actuaries established under subtitle C of the title III of the Employee Retirement Income Security Act of 1974.

(36) Income tax return preparer

(A) In general

The term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

(B) Exceptions

A person shall not be an "income tax return preparer" merely because such person -

(i) furnishes typing, reproducing, or other mechanical assistance,

(ii) prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,

(iii) prepares as a fiduciary a return or claim for refund for any person, or

(iv) prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

(37) Individual retirement plan

The term "individual retirement plan" means -

(A) an individual retirement account described in section 408(a), and

(B) an individual retirement annuity described in section 408(b).

(38) Joint return

The term "joint return" means a single return made jointly under section 6013 by a husband and wife.

(39) Persons residing outside United States

If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of any provision of this title relating to -

(A) jurisdiction of courts, or

(B) enforcement of summons.

(40) Indian tribal government

(A) In general

The term "Indian tribal government" means the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary, after consultation with the Secretary of the

Interior, to exercise governmental functions.

(B) Special rule for Alaska Natives

No determination under subparagraph (A) with respect to Alaska Natives shall grant or defer any status or powers other than those enumerated in section 7871. Nothing in the Indian Tribal Governmental Tax Status Act of 1982, or in the amendments made thereby, shall validate or invalidate any claim by Alaska Natives of sovereign authority over lands or people.

(41) TIN

The term "TIN" means the identifying number assigned to a person under section 6109.

(42) Substituted basis property

The term "substituted basis property" means property which is -

(A) transferred basis property, or

(B) exchanged basis property.

(43) Transferred basis property

The term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) Exchanged basis property

The term "exchanged basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) Nonrecognition transaction

The term "nonrecognition transaction" means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

(46) Determination of whether there is a collective bargaining agreement

In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term "employee representatives" shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer. An agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and 1 or more employers.

(b) Definition of resident alien and nonresident alien

(1) In general

For purposes of this title (other than subtitle B) -

(A) Resident alien

An alien individual shall be treated as a resident of the

United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i), (ii), or (iii):

(i) Lawfully admitted for permanent residence

Such individual is a lawful permanent resident of the United States at any time during such calendar year.

(ii) Substantial presence test

Such individual meets the substantial presence test of paragraph (3).

(iii) First year election

Such individual makes the election provided in paragraph (4).

(B) Nonresident alien

An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

(2) Special rules for first and last year of residency

(A) First year of residency

(i) In general

If an alien individual is a resident of the United States under paragraph (1)(A) with respect to any calendar year, but was not a resident of the United States at any time during the preceding calendar year, such alien individual shall be treated as a resident of the United States only for the portion of such calendar year which begins on the residency starting date.

(ii) Residency starting date for individuals lawfully admitted for permanent residence

In the case of an individual who is a lawfully permanent resident of the United States at any time during the calendar year, but does not meet the substantial presence test of paragraph (3), the residency starting date shall be the first day in such calendar year on which he was present in the United States while a lawful permanent resident of the United States.

(iii) Residency starting date for individuals meeting substantial presence test

In the case of an individual who meets the substantial presence test of paragraph (3) with respect to any calendar year, the residency starting date shall be the first day during such calendar year on which the individual is present in the United States.

(iv) Residency starting date for individuals making first year election

In the case of an individual who makes the election provided by paragraph (4) with respect to any calendar year, the residency starting date shall be the 1st day during such calendar year on which the individual is treated as a resident of the United States under that paragraph.

(B) Last year of residency
An alien individual shall not be treated as a resident of the United States during a portion of any calendar year if -
(i) such portion is after the last day in such calendar year on which the individual was present in the United States (or, in the case of an individual described in paragraph (1)(A)(i), the last day on which he was so described),
(ii) during such portion the individual has a closer connection to a foreign country than to the United States, and
(iii) the individual is not a resident of the United States at any time during the next calendar year.
(C) Certain nominal presence disregarded
(i) In general
For purposes of subparagraphs (A)(iii) and (B), an individual shall not be treated as present in the United States during any period for which the individual establishes that he has a closer connection to a foreign country than to the United States.
(ii) Not more than 10 days disregarded
Clause (i) shall not apply to more than 10 days on which the individual is present in the United States.
(3) Substantial presence test
(A) In general
Except as otherwise provided in this paragraph, an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this subsection referred to as the "current year") if -
(i) such individual was present in the United States on at least 31 days during the calendar year, and
(ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

In the case of days in:	The applicable multiplier is:
Current year	1
1st preceding year	1/3
2nd preceding year	1/6

(B) Exception where individual is present in the United States during less than one-half of current year and closer connection to foreign country is established
An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if -
(i) such individual is present in the United States on fewer than 183 days during the current year, and

(ii) it is established that for the current year such individual has a tax home (as defined in section 911(d)(3) without regard to the second sentence thereof) in a foreign country and has a closer connection to such foreign country than to the United States.

(C) Subparagraph (B) not to apply in certain cases

Subparagraph (B) shall not apply to any individual with respect to any current year if at any time during such year -

(i) such individual had an application for adjustment of status pending, or

(ii) such individual took other steps to apply for status as a lawful permanent resident of the United States.

(D) Exception for exempt individuals or for certain medical conditions

An individual shall not be treated as being present in the United States on any day if -

(i) such individual is an exempt individual for such day, or

(ii) such individual was unable to leave the United States on such day because of a medical condition which arose while such individual was present in the United States.

(4) First-year election

(A) An alien individual shall be deemed to meet the requirements of this subparagraph if such individual -

(i) is not a resident of the United States under clause (i) or (ii) of paragraph (1)(A) with respect to a calendar year (hereinafter referred to as the "election year"),

(ii) was not a resident of the United States under paragraph (1)(A) with respect to the calendar year immediately preceding the election year,

(iii) is a resident of the United States under clause (ii) of paragraph (1)(A) with respect to the calendar year immediately following the election year, and

(iv) is both -

(I) present in the United States for a period of at least 31 consecutive days in the election year, and

(II) present in the United States during the period beginning with the first day of such 31-day period and ending with the last day of the election year (hereinafter referred to as the "testing period") for a number of days equal to or exceeding 75 percent of the number of days in the testing period (provided that an individual shall be treated for purposes of this subclause as present in the United States for a number of days during the testing period not exceeding 5 days in the aggregate, notwithstanding his absence from the United States on such days).

(B) An alien individual who meets the requirements of subparagraph (A) shall, if he so elects, be treated as a resident

of the United States with respect to the election year.
(C) An alien individual who makes the election provided by subparagraph (B) shall be treated as a resident of the United States for the portion of the election year which begins on the 1st day of the earliest testing period during such year with respect to which the individual meets the requirements of clause (iv) of subparagraph (A).
(D) The rules of subparagraph (D)(i) of paragraph (3) shall apply for purposes of determining an individual's presence in the United States under this paragraph.
(E) An election under subparagraph (B) shall be made on the individual's tax return for the election year, provided that such election may not be made before the individual has met the substantial presence test of paragraph (3) with respect to the calendar year immediately following the election year.
(F) An election once made under subparagraph (B) remains in effect for the election year, unless revoked with the consent of the Secretary.
(5) Exempt individual defined
For purposes of this subsection -
(A) In general
An individual is an exempt individual for any day if, for such day, such individual is -
(i) a foreign government-related individual,
(ii) a teacher or trainee,
(iii) a student, or
(iv) a professional athlete who is temporarily in the United States to compete in a charitable sports event described in section 274(l)(1)(B).
(B) Foreign government-related individual
The term "foreign government-related individual" means any individual temporarily present in the United States by reason of -
(i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,
(ii) being a full-time employee of an international organization, or
(iii) being a member of the immediate family of an individual described in clause (i) or (ii).
(C) Teacher or trainee
The term "teacher or trainee" means any individual -
(i) who is temporarily present in the United States under subparagraph (J) or (Q) of section 101(15) of the Immigration and Nationality Act (other than as a student), and
(ii) who substantially complies with the requirements for being so present.
(D) Student

The term "student" means any individual -
(i) who is temporarily present in the United States -
(I) under subparagraph (F) or (M) of section 101(15) of the Immigration and Nationality Act, or
(II) as a student under subparagraph (J) or (Q) of such section 101(15), and

(ii) who substantially complies with the requirements for being so present.
(E) Special rules for teachers, trainees, and students
(i) Limitation on teachers and trainees
An individual shall not be treated as an exempt individual by reason of clause (ii) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A). In the case of an individual all of whose compensation is described in section 872(b)(3), the preceding sentence shall be applied by substituting "4 calendar years" for "2 calendar years".
(ii) Limitation on students
For any calendar year after the 5th calendar year for which an individual was an exempt individual under clause (ii) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (D)(ii).
(6) Lawful permanent resident
For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if -
(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and
(B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).
(7) Presence in the United States
For purposes of this subsection -
(A) In general
Except as provided in subparagraph (B), (C), or (D), an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.
(B) Commuters from Canada or Mexico
If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence

in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

(C) Transit between 2 foreign points

If an individual, who is in transit between 2 points outside the United States, is physically present in the United States for less than 24 hours, such individual shall not be treated as present in the United States on any day during such transit.

(D) Crew members temporarily present

An individual who is temporarily present in the United States on any day as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States shall not be treated as present in the United States on such day unless such individual otherwise engages in any trade or business in the United States on such day.

(8) Annual statements

The Secretary may prescribe regulations under which an individual who (but for subparagraph (B) or (D) of paragraph (3)) would meet the substantial presence test of paragraph (3) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B) or (D) of paragraph (3), as the case may be.

(9) Taxable year

(A) In general

For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

(B) Fiscal year taxpayer

If -

(i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and

(ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year,

he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year.

(10) Coordination with section 877

If -

(A) an alien individual was treated as a resident of the United States during any period which includes at least 3 consecutive calendar years (hereinafter referred to as the "initial residency period"), and

(B) such individual ceases to be treated as a resident of the United States but subsequently becomes a resident of the United States before the close of the 3rd calendar year beginning after the close of the initial residency period, such individual shall be taxable for the period after the close of the initial residency period and before the day on which he subsequently became a resident of the United States in the manner provided in section 877(b). The preceding sentence shall apply only if the tax imposed pursuant to section 877(b) exceeds the tax which, without regard to this paragraph, is imposed pursuant to section 871.

(11) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(c) Includes and including

The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.

(d) Commonwealth of Puerto Rico

Where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, references in this title to possessions of the United States shall be treated as also referring to the Commonwealth of Puerto Rico.

(e) Treatment of certain contracts for providing services, etc.

For purposes of chapter 1 -

(1) In general

A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not -

(A) the service recipient is in physical possession of the property,

(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,

(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

(2) Other arrangements

An arrangement (including a partnership or other pass-thru entity) which is not described in paragraph (1) shall be treated as a lease if such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in paragraph (1).

(3) Special rules for contracts or arrangements involving solid waste disposal, energy, and clean water facilities

(A) In general

Notwithstanding paragraphs (1) and (2), and except as provided in paragraph (4), any contract or arrangement between a service provider and a service recipient -

(i) with respect to -

(I) the operation of a qualified solid waste disposal facility,

(II) the sale to the service recipient of electrical or thermal energy produced at a cogeneration or alternative energy facility, or

(III) the operation of a water treatment works facility, and

(ii) which purports to be a service contract,

shall be treated as a service contract.

(B) Qualified solid waste disposal facility

For purposes of subparagraph (A), the term "qualified solid waste disposal facility" means any facility if such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public.

(C) Cogeneration facility

For purposes of subparagraph (A), the term "cogeneration facility" means a facility which uses the same energy source for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy.

(D) Alternative energy facility

For purposes of subparagraph (A), the term "alternative energy facility" means a facility for producing electrical or thermal energy if the primary energy source for the facility is not oil, natural gas, coal, or nuclear power.

(E) Water treatment works facility

For purposes of subparagraph (A), the term "water treatment works facility" means any treatment works within the meaning of section 212(2) of the Federal Water Pollution Control Act.

(4) Paragraph (3) not to apply in certain cases

(A) In general

Paragraph (3) shall not apply to any qualified solid waste disposal facility, cogeneration facility, alternative energy facility, or water treatment works facility used under a contract or arrangement if -

(i) the service recipient (or a related entity) operates such facility,

(ii) the service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement (other than for reasons beyond the control of the service provider),

(iii) the service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement, or

(iv) the service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or a part of such facility at a fixed and determinable price (other than for fair market value).

For purposes of this paragraph, the term "related entity" has the same meaning as when used in section 168(h).

(B) Special rules for application of subparagraph (A) with respect to certain rights and allocations under the contract

For purposes of subparagraph (A), there shall not be taken into account -

(i) any right of a service recipient to inspect any facility, to exercise any sovereign power the service recipient may possess, or to act in the event of a breach of contract by the service provider, or

(ii) any allocation of any financial burden or benefits in the event of any change in any law.

(C) Special rules for application of subparagraph (A) in the case of certain events

(i) Temporary shut-downs, etc.

For purposes of clause (ii) of subparagraph (A), there shall not be taken into account any temporary shut-down of the facility for repairs, maintenance, or capital improvements, or any financial burden caused by the bankruptcy or similar financial difficulty of the service provider.

(ii) Reduced costs

For purposes of clause (iii) of subparagraph (A), there shall not be taken into account any significant financial benefit merely because payments by the service recipient under the contract or arrangement are decreased by reason of increased production or efficiency or the recovery of energy or other products.

(5) Exception for certain low-income housing

This subsection shall not apply to any property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B) (relating to low-income housing) if -

(A) such property is operated by or for an organization described in paragraph (3) or (4) of section 501(c), and

(B) at least 80 percent of the units in such property are leased to low-income tenants (within the meaning of section 167(k)(3)(B)) (as in effect on the day before the date of the enactment of the Revenue Reconcilation (!3) Act of 1990).

(6) Regulations

The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this subsection.

(f) Use of related persons or pass-thru entities

The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with -

(1) the linking of borrowing to investment, or

(2) diminishing risks,

through the use of related persons, pass-thru entities, or other intermediaries.

(g) Clarification of fair market value in the case of nonrecourse indebtedness

For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

(h) Motor vehicle operating leases

(1) In general

For purposes of this title, in the case of a qualified motor vehicle operating agreement which contains a terminal rental adjustment clause -

(A) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and

(B) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect.

(2) Qualified motor vehicle operating agreement defined

For purposes of this subsection -

(A) In general

The term "qualified motor vehicle operating agreement" means any agreement with respect to a motor vehicle (including a trailer) which meets the requirements of subparagraphs (B), (C), and (D) of this paragraph.

(B) Minimum liability of lessor

An agreement meets the requirements of this subparagraph if under such agreement the sum of -

(i) the amount the lessor is personally liable to repay, and

(ii) the net fair market value of the lessor's interest in any property pledged as security for property subject to the agreement,

equals or exceeds all amounts borrowed to finance the acquisition of property subject to the agreement. There shall not be taken into account under clause (ii) any property pledged which is property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement.

(C) Certification by lessee; notice of tax ownership

An agreement meets the requirements of this subparagraph if such agreement contains a separate written statement separately signed by the lessee -

(i) under which the lessee certifies, under penalty of perjury, that it intends that more than 50 percent of the use of the property subject to such agreement is to be in a trade or business of the lessee, and

(ii) which clearly and legibly states that the lessee has been advised that it will not be treated as the owner of the property subject to the agreement for Federal income tax purposes.

(D) Lessor must have no knowledge that certification is false

An agreement meets the requirements of this subparagraph if the lessor does not know that the certification described in subparagraph (C)(i) is false.

(3) Terminal rental adjustment clause defined

(A) In general

For purposes of this subsection, the term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

(B) Special rule for lessee dealers

The term "terminal rental adjustment clause" also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provision achieves substantially the same results as a provision described in subparagraph (A).

(i) Taxable mortgage pools

(1) Treated as separate corporations

A taxable mortgage pool shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of section 1501.

(2) Taxable mortgage pool defined

For purposes of this title -

(A) In general

Except as otherwise provided in this paragraph, a taxable mortgage pool is any entity (other than a REMIC or a FASIT) if -

(i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein),

(ii) such entity is the obligor under debt obligations with 2 or more maturities, and

(iii) under the terms of the debt obligations referred to in clause (ii) (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the debt obligations (or interests) referred to in clause (i).

(B) Portion of entities treated as pools

Any portion of an entity which meets the definition of subparagraph (A) shall be treated as a taxable mortgage pool.

(C) Exception for domestic building and loan

Nothing in this subsection shall be construed to treat any domestic building and loan association (or portion thereof) as a taxable mortgage pool.

(D) Treatment of certain equity interests

To the extent provided in regulations, equity interest of varying classes which correspond to maturity classes of debt shall be treated as debt for purposes of this subsection.

(3) Treatment of certain REIT's

If -

(A) a real estate investment trust is a taxable mortgage pool, or

(B) a qualified REIT subsidiary (as defined in section 856(i)(2)) of a real estate investment trust is a taxable mortgage pool,

under regulations prescribed by the Secretary, adjustments similar to the adjustments provided in section 860E(d) shall apply to the shareholders of such real estate investment trust.

(j) Tax treatment of Federal Thrift Savings Fund

(1) In general

For purposes of this title -

(A) the Thrift Savings Fund shall be treated as a trust described in section 401(a) which is exempt from taxation under section 501(a);

(B) any contribution to, or distribution from, the Thrift Savings Fund shall be treated in the same manner as contributions to or distributions from such a trust; and

(C) subject to section 401(k)(4)(B) and any dollar limitation on the application of section 402(e)(3), contributions to the Thrift Savings Fund shall not be treated as distributed or made available to an employee or Member nor as a contribution made to the Fund by an employee or Member merely because the employee or Member has, under the provisions of subchapter III of chapter 84 of title 5, United States Code, and section 8351 of such title 5, an election whether the contribution will be made to the Thrift Savings Fund or received by the employee or Member in cash.

(2) Nondiscrimination requirements

Notwithstanding any other provision of law, the Thrift Savings

Fund is not subject to the nondiscrimination requirements applicable to arrangements described in section 401(k) or to matching contributions (as described in section 401(m)), so long as it meets the requirements of this section.

(3) Coordination with Social Security Act

Paragraph (1) shall not be construed to provide that any amount of the employee's or Member's basic pay which is contributed to the Thrift Savings Fund shall not be included in the term "wages" for the purposes of section 209 of the Social Security Act or section 3121(a) of this title.

(4) Definitions

For purposes of this subsection, the terms "Member", "employee", and "Thrift Savings Fund" shall have the same respective meanings as when used in subchapter III of chapter 84 of title 5, United States Code.

(5) Coordination with other provisions of law

No provision of law not contained in this title shall apply for purposes of determining the treatment under this title of the Thrift Savings Fund or any contribution to, or distribution from, such Fund.

(k) Treatment of certain amounts paid to charity

In the case of any payment which, except for section 501(b) of the Ethics in Government Act of 1978, might be made to any officer or employee of the Federal Government but which is made instead on behalf of such officer or employee to an organization described in section 170(c) -

(1) such payment shall not be treated as received by such officer or employee for all purposes of this title and for all purposes of any tax law of a State or political subdivision thereof, and

(2) no deduction shall be allowed under any provision of this title (or of any tax law of a State or political subdivision thereof) to such officer or employee by reason of having such payment made to such organization.

For purposes of this subsection, a Senator, a Representative in, or a Delegate or Resident Commissioner to, the Congress shall be treated as an officer or employee of the Federal Government.

(l) Regulations relating to conduit arrangements

The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title.

(m) Designation of contract markets

Any designation by the Commodity Futures Trading Commission of a contract market which could not have been made under the law in effect on the day before the date of the enactment of the Commodity Futures Modernization Act of 2000 shall apply for purposes of this

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title except to the extent provided in regulations prescribed by
the Secretary.
(n) Cross references
  (1) Other definitions
      For other definitions, see the following sections of Title 1
    of the United States Code:
        (1) Singular as including plural, section 1.
        (2) Plural as including singular, section 1.
        (3) Masculine as including feminine, section 1.
        (4) Officer, section 1.
        (5) Oath as including affirmation, section 1.
        (6) County as including parish, section 2.
        (7) Vessel as including all means of water transportation,
      section 3.
        (8) Vehicle as including all means of land transportation,
      section 4.
        (9) Company or association as including successors and
      assigns, section 5.
  (2) Effect of cross references
      For effect of cross references in this title, see section
    7806(a).
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[Notes] Next

legal investigators, mediators, couriers, paralegals, and court reporters.

U.S. Code collection

CHAPTER 79—DEFINITIONS

How Current is This?

CITES BY TOPIC: State

Black's Law Dictionary, Sixth Edition, p. 1407:

> *"State. A people permanently occupying a fixed territory bound together by common-law habits and custom into one body politic exercising, through the medium of an organized government, independent sovereignty and control over all persons and things within its boundaries, capable of making war and peace and of entering into international relations with other communities of the globe. United States v. Kusche, D.C.Cal., 56 F.Supp. 201 207, 208. The organization of social life which exercises sovereign power in behalf of the people. Delany v. Moralitis, C.C.A.Md., 136 F.2d 129, 130. **In its largest sense, a "state" is a body politic or a society of men.** Beagle v. Motor Vehicle Acc. Indemnification Corp., 44 Misc.2d 636, 254 N.Y.S.2d 763, 765. **A body of people occupying a definite territory and politically organized under one government.** State ex re. Maisano v. Mitchell, 155 Conn. 256, 231 A.2d 539, 542. A territorial unit with a distinct general body of law. Restatement, Second, Conflicts, §3. Term may refer either to body politic of a nation (e.g. United States) or to an individual government unit of such nation (e.g. California).*
>
> *[…]*
>
> ***The people of a state, in their collective capacity**, considered as the party wronged by a criminal deed; the public; as in the title of a cause, "The State vs. A.B." [Black's Law Dictionary, Sixth Edition, p. 1407]*

WORDS AND PHRASES: "STATE"-detailed analysis of the word "STATE" from THE AUTHORITY

"State" defined in 18 Stat 3140-definition back when politicians and lawyers were more honest

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DISTINCTION BETWEEN "State"/"Territory" v. "state", FROM GREAT IRS HOAX, SECTION 4.8:

> Let us carefully clarify the important distinctions between "States", "territories", and "states" in the context of federal statutes to make our analysis crystal clear. Remember that federal "territories" and "States" are synonymous as per 4 U.S.C. §110(d). Keep in mind also that Indian reservations, while considered "sovereign nations" are also federal "States":
>
> Table 4-5: Attributes of "State"/"Territory" v. "state"

#	*Attribute*	*Authority*	*"State" or "Territory" of the "United States"*	*"state"/ Union state*
1	Federal government has "police powers" (e.g. criminal jurisdiction) here?	Tenth Amendment to U.S. Constitution	Yes	No
2	Constitution Article 1, Section 8, Clause 17 jurisdiction?	U.S. v. Bevans, 16 U.S. 336 (1818)	Yes	No
3	"foreign state" relative to the federal government?	Black's Law Dictionary, Sixth Edition definition of "foreign state" and "foreign laws"	No	Yes
4	No "legislative jurisdiction" (federal statutes, like IRC) jurisdiction without state cession?	40 U.S.C. §255	No	Yes

5	Federal courts in the region act under the authority of what Constitutional provision?:	Constitution Articles II and III.	Article II *legislative* courts (no mandate for trial by jury)	Article III *Constitutional* courts (mandatory trial by jury)
6	Diversity of citizenship applies here?	28 U.S.C. §1332	No	Yes
7	Citizenship of persons born here:	8 U.S.C. §1401 and 8 U.S.C. §1408	"U.S. citizen"	"U.S. national"
8	Bill of rights (first ten amendments to the U.S. Constitution) applies here?	Downes v. Bidwell, 182 U.S. 244 (1901)	No	Yes
9	Listed in Title 48 as a "Territory or possession"?	Title 48, U.S. Codes	Yes	No
10	Local governments here have "sovereign immunity" relative to federal government?	28 U.S.C. §1346(b) Eleventh Amendment to U.S. Const.	No	Yes

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4 U.S.C. §110(d)

TITLE 4 - FLAG AND SEAL, SEAT OF GOVERNMENT, AND THE STATES
CHAPTER 4 - THE STATES

Sec. 110. Same; definitions
(d) The term ''State'' includes any Territory or possession of the United States.

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8 U.S.C. Sec. 1101(a)(36)

(a) Definitions

(36) State [Aliens and Nationality]

The term "State" includes the District of Columbia, Puerto Rico, Guam, and the Virgin Islands of the United States.

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26 U.S.C. Sec. 7701(a)(10)

(a) Definitions

(10)State

The term "State" shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

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28 U.S.C. 1332(d)

TITLE 28 > PART IV > CHAPTER 85 > Sec. 1332. [Judiciary and Judicial Procedure]

Sec. 1332. - Diversity of citizenship; amount in controversy; costs

(d) The word "**S**tates", as used in this section, includes the Territories, the District of Columbia, and the

Commonwealth of Puerto Rico

[40 U.S.C. §319c]

TITLE 40 > CHAPTER 4 > Sec. 319c.

Sec. 319c. - Definitions for easement provisions

As used in sections 319 to 319c of this title -

(a) The term "State" **means** the **States of the Union**, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States.

Uniform Commercial Code (UCC) Section 9 -102 (76)

(76) "State" means a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

Eisenberg v. Commercial Union Assurance Company, 189 F.Supp. 500 (1960)

(d) the word "States", as used in this section [Title 28 §1332 as amended in 1958] includes the Territories, the District of Columbia, and the Commonwealth of Puerto Rico.

It is to be noted that the statute differentiates between **S**tates of the United States and foreign states by the use of the **capital S** for the word when applied to a State of the United States."

Cherokee Nation v. The State of Georgia, 30 U.S. 1; 8 L.Ed. 25 (1831):

"The Cherokee Nation is not a foreign state, in the sense in which the term 'foreign state' is used in the Constitution of the United States."

"The Cherokees are a State."

"The acts of our government plainly recognize the Cherokee Nation as a State, and the courts are bound by those acts."

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49 U.S.C. §13102: Definitions

(18) State. - The term "State" means the 50 States of the United States and the District of Columbia.

U.S. v. Reese, 92 U.S. 214 (1875):

The word 'State' 'describes sometimes a people or community of individuals united more or less closely in political relations, inhabiting temporarily or permanently the same country; often it denotes only the country or territorial region inhabited by such a community; not unfrequently it is applied to the government under which the people live; at other times it represents the combined idea of people, territory, and government. It is not difficult to see, that, in all these senses, the primary conception is that of a people or community. The people, in whatever territory dwelling, either temporarily or permanently, and whether organized under a regular government or united by looser and less definite relations, constitute the State. . . . In the Constitution, the term 'State' most frequently expresses the combined idea just noticed, of people, territory, and government. A State, in the ordinary sense of the Constitution, is a political community of free citizens, occupying a territory of defined boundaries, organized under a government sanctioned and limited by a written constitution, and established by the consent of the governed. It is the union of such States under a common constitution which forms the distinct and greater political unit which that constitution designates as the United States, and makes of the people and States which compose it one people and one country.' Texas v. White, 7 Wall. 720, 721.

That the word 'State' is not confined in its meaning to the legislative power of a community is evident, not only from the authority just cited, but from a reference to the various places in which it is used in the Constitution of the United States. A few only of these will be referred to.

Words and Phrases, Vol. 40, p. 20:

United States

"The classical designation to clearly indicate the states as individual governmental entities making up the United Nation, dating form the Constitution and coming down through various acts of Congress and pronouncements of the courts, is the word "states". Twin Falls County v. Hulbert, 156 P.2d 319, 324, 325, 66 Idaho 128.

"Generally the word "state" when used by court or Legislature [in federal statutes, for instance, of which the Internal Revenue Code is a part] denotes one of the members of the federal Union. Twin Falls County v. Hulbert, 156 P.2d 319, 324, 235, 66 Idaho 128."

"**The word "state" is generally used in connection with constitutional law in United States as meaning individual states making up the Union in contradistinction to United States as a nation, but United States is a "state" as such word is frequently used in international law, or to carry out legislative intent expressed in statute. McLaughlin v. Poucher, 17 A.2d 767, 770, 127 Conn. 441.**"

Downes v. Bidwell, 182 U.S. 244 (1901)

"The earliest case is that of Hepburn v. Ellzey, 2 Cranch, 445, 2 L. ed. 332, in which this court held that, under that clause of the Constitution limiting the jurisdiction of the courts of the United States to controversies between citizens of different states, a citizen of the District of Columbia could not maintain an action in the circuit court of the United States. It was argued that the word 'state.' in that connection, was used simply to denote a distinct political society. 'But,' said the Chief Justice, 'as the act of Congress obviously used the word 'state' in reference to that term as used in the Constitution, it becomes necessary to inquire whether Columbia is a state in the sense of that instrument. **The result of that examination is a conviction that the members of the American confederacy only are the states contemplated in the Constitution , . . . and excludes from the term the signification attached to it by writers on the law of nations.' This case was followed in Barney v. Baltimore, 6 Wall. 280, 18 L. ed. 825, and quite recently in Hooe v. Jamieson, 166 U.S. 395 , 41 L. ed. 1049, 17 Sup. Ct. Rep. 596. The same rule was applied to citizens of territories in New Orleans v. Winter, 1 Wheat. 91, 4 L. ed. 44, in which an attempt was made to distinguish a territory from the District of Columbia. But it was said that 'neither of them is a state in the sense in which that term is used in the Constitution.'** In Scott v. Jones, 5 How. 343, 12 L. ed. 181, and in Miners' Bank v. Iowa ex rel. District Prosecuting Attorney, 12 How. 1, 13 L. ed. 867, it was held that under the judiciary act, permitting writs of error to the supreme court of a state in cases where the validity of a state statute is drawn in question, an act of a territorial legislature was not within the contemplation of Congress." [Downes v. Bidwell, 182 U.S. 244 (1901)]

Albert J. Nock, America Mercury Magazine, march 1939:

> "[T]he State's criminality is nothing new and nothing to be wondered at. It began when the first predatory group of men clustered together and formed the State, and it will continue as long as the State exists in the world, because the State is fundamentally an anti-social institution, fundamentally criminal. The idea that the State originated to serve any kind of social purpose is completely unhistorical. It originated in conquest and confiscation -- that is to say, in crime. It originated for the purpose of maintaining the division of society into an owning-and-exploiting class and a propertyless dependent class -- that is, for a criminal purpose. No State known to history originated in any other manner, or for any other purpose. Like all predatory or parasitic institutions, its first instinct is that of self-preservation. All its enterprises are directed first towards preserving its own life, and, second, towards increasing its own power and enlarging the scope of its own activity. For the sake of this it will, and regularly does, commit any crime which circumstances make expedient." [Albert Jay Nock (1870-1945), Source: The Criminality of the State, America Mercury Magazine, March, 1939]

BACKGROUND ON "STATE" FROM THE PREFACE OF THE GREAT IRS HOAX:

> **State** — in the context of federal statutes, federal court rulings, and this book means a federal State of the United States, the District of Columbia, Guam, Puerto Rico, Virgin Islands, Northern Marina Islands, and includes areas within the external boundaries of a state owned by or ceded to the United States of America. Federal "States" are defined in 4 U.S.C. §110(d) and 26 U.S.C. §7701(a)(10). In the context of the U.S. Constitution only, "State" means a sovereign "state" as indicated below. The reason the constitution is different is because of who wrote it. The states wrote it so they are capitalized. Federal statutes are not written by the sovereign states so they use the lower case "state" to describe the sovereign 50 union states, which are foreign to the federal government and outside its territorial jurisdiction.

"It is to be noted that the statute differentiates between States of the United States and foreign states by the use of a capital S for the word when applied to a State of the United States" Eisenberg v. Commercial Union Assurance Company, 189 F.Supp. 500 (1960)

> **state** — in the context of federal statutes, federal court rulings, and this book means a sovereign state of the Union of America under the Constitution for the United States of America 1789-1791. In the context of the U.S. Constitution only, "State" means a sovereign "state" as defined here. Below is a further clarification of the meaning of "states" as defined by the U.S. Supreme Court in the case of ***O'Donoghue v. United States***, 289 U.S. 516 (1933), where they define what is *not* a "state":
>
> *After an exhaustive review of the prior decisions of this court relating to the matter, the following propositions, among others, were stated as being established:*
>
> *'1. That the District of Columbia and the territories are **not states** within the judicial clause of the Constitution giving jurisdiction in cases between citizens of different states;*
>
> *'2. That territories are **not states** within the meaning of Rev. St. 709, permitting writs of error from this court in cases where the validity of a state statute is drawn in question;*
>
> *'3. That **the District of Columbia and the territories are states as that word is used in treaties with foreign powers, with respect to the ownership, disposition, and inheritance of property**;*
>
> *'4. That the territories are not within the clause of the Constitution providing for the creation of a supreme court and such inferior courts as Congress may see fit to establish.'*

Below is a summary of the meanings of "state" and "State" in the context of both federal and state laws:

Table 1: Summary of meaning of "state" and "State"

Law	**Federal constitution**	**Federal statutes**	**Federal regulations**	**State constitutions**	**State statutes**	**State regulations**
Author	**Union States/ "We The People"**	**Federal Government**		**"We The People"**	**State Government**	
"state"	Foreign country	Union state	Union state	Other Union state or federal government	Other Union state or federal government	Other Union state or federal government
"State"	Union state	Federal state	Federal state	Union state	Union state	Union state
"in this State" or "in the State"[1]	NA	NA	NA	NA	Federal enclave within state	Federal enclave within state
"State"[2] (State Revenue and taxation code only)	NA	NA	NA	NA	Federal enclave within state	Federal enclave within state

So what the above table clearly shows is that the word "State" in the context of federal statutes and regulations means (not includes!) federal States only under Title 48 of the U.S. Code[3], and these areas do not include any of the 50 union states. This is true in *most cases and especially in the Internal Revenue Code*, but there are a few minor exceptions: For example in 40 U.S.C. §319c. The word "State" in the context of federal statutes and regulations means one of the 50 union states, which are "foreign states", and "foreign countries" with respect to the federal government as clearly explained later in section 5.2.11 of this book. In the context of the above, a "Union State" means one of the 50 Union states of the United States* (the country, not the federal United States**). The capitalization of the word "State" therefore ***always*** depends on the context in which it is used.

"Text, without context, is error."

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[1] See California Revenue and Taxation Code, section 6017 at http://www.leginfo.ca.gov/cgi-bin/displaycode?section=rtc&group=06001-07000&file=6001-6024

[2] See California Revenue and Taxation Code, section 17018 at http://www.leginfo.ca.gov/cgi-bin/displaycode?section=rtc&group=17001-18000&file=17001-17039.1

[3] See http://www4.law.cornell.edu/uscode/48/