

# **TAXABLE INCOME**

[Revised: 4/15/2002]

Larken Rose

*[www.taxableincome.net](http://www.taxableincome.net)*

## Table of Contents

1) Overview	Page 1
2) The Basics	Page 2
3) English vs. Legalese	Page 3
4) Sources of Income	Page 4
5) Determining Taxable Income	Page 5
6) Specific Sources	Page 7
7) Operative Sections	Page 10
8) Summary of Current Law	Page 11
9) Taxing Power	Page 12
10) Constitutional Limits	Page 14
11) Exempt Income	Page 18
12) Intent to Deceive	Page 20
13) Cover-Up of 1954	Page 21
14) Other Cover-Ups	Page 27
15) Clues and Hints	Page 32
16) The Other Side	Page 39
17) Conclusion	Page 56

Also included (after the report):

- Chart of the current Part I of Subchapter N (and regulations).
- Chart of the predecessor to Part I (and regulations).
- Questions and Exhibits of “Operation Honest Inquiry.”

## 1) Overview

Despite “common knowledge” to the contrary, the income of most Americans is *not* subject to the United States federal income tax. The strict limits on federal power imposed by the Constitution prohibited Congress from imposing a tax on the income of U.S. citizens who live and work exclusively within the 50 states, and the federal statutes and regulations themselves demonstrate that Congress *did not* impose such a tax. This was not due to an oversight or to some technical imperfection in the legislative process. Congress never *attempted* to impose such a tax. Instead, Congress imposed a far more limited income tax, applicable primarily to income derived from certain international and foreign commerce. However, that law was written in such a way that if the reader did not know where to look in the law, he was likely to get the incorrect impression that his income was taxable. However, other sections show that only income derived from “specific sources,” which are all related to international or foreign commerce, is subject to the tax.

While following the proof of this may require concentration, it does *not* require any “leap of faith,” or any questionable “interpretation” of the law. The legal system of the United States is a system of written law, and the words in the law must inform individuals of exactly what the law requires. Therefore, an accurate determination of what the law requires can be accomplished only by an examination of the relevant legal documents themselves, without regard for preconceived assumptions about what the law says. Despite the enormous, complex maze of federal statutes and regulations built up by government lawyers over the years, written in what is virtually a foreign language to most (sometimes called “legalese”), the truth is still quite provable, as will be shown below.

Though many have complained about and/or resisted the federal income tax, the truth is that most Americans have no reason at all to “protest” the tax. The federal income tax is neither invalid nor unconstitutional. What *does* warrant protest and demand for correction is how the tax has been (and continues to be) grossly misrepresented to the American people and misapplied by federal employees. Many citizens have been harassed, robbed, and unjustly imprisoned, and the few in government who knew the truth did nothing to stop it.

Political power has long been associated with dishonesty and deception, but the misrepresentation of the federal income tax (referred to below as “the Great Deception”) constitutes the most massive financial fraud in the history of mankind. (It is more a conspiracy of ignorance than a conspiracy of secrecy, meaning that most IRS employees and tax professionals are guilty of incompetence and ignorance, rather than intentional deceit.)

Following the main report are included the three questions of “Operation Honest Inquiry” regarding the specific wording of the regulations under Section 861, along with related exhibits, which have baffled government officials and tax professionals alike.

[All underline emphasis and non-italicized comments (in brackets) within a citation in this report are additions by the author, and do not appear in the text itself.]

## 2) The Basics

The laws enacted by Congress through the legislative process are compiled into statutes of the United States Code. Each of the 50 “titles” of the United States Code deals with a category of federal law, with Title 26 being the federal tax title, also called the “Internal Revenue Code.” Federal agencies are empowered (by Congressional statute) to implement and enforce the statutes by writing and publishing regulations, which explain the agencies’ interpretation of the statutes, as well as setting the rules which govern how the agency will enforce the statutes. The regulations, when published in the Federal Register, are the official notice to the public of what the law requires of them (Federal Register Act, 44 USC), and are binding on the federal agencies, including the IRS. For federal taxes, the Secretary of the Treasury is authorized to write the regulations.

*“Sec. 7805. Rules and regulations*

*(a) Authorization - ... the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title [meaning Title 26]...” [26 USC § 7805]*

(The citation “26 USC § 7805” refers to Section 7805 of the *statutes* of Title 26, with “USC” meaning “United States Code.” The symbol “§” means “section.” Citations of *regulations* are similar, but contain “CFR” instead, meaning “Code of Federal Regulations.”)

Section 1 of the Title 26 statutes imposes the “income tax” on five categories of individuals (unmarried people, married people filing jointly, etc.). In each case, the wording reads, “*there is hereby imposed on the taxable income of...*” The law generally defines “*taxable income*” in the following section of the statutes:

*“Sec. 63. Taxable income defined*

*(a) In general - ...the term "taxable income" means gross income minus the deductions allowed by this chapter...” [26 USC § 63]*

In other words, when someone determines his “*gross income*,” and subtracts the allowable deductions, the remainder is “*taxable income*.” So for income to be “*taxable income*” it must first be “*gross income*.” The statutes generally define “gross income” as follows:

*“Sec. 61. Gross income defined*

*(a) General definition - ... gross income means all income from whatever source derived, including (but not limited to) the following items:*

- (1) Compensation for services...;*
- (2) Gross income derived from business;*
- (3) Gains derived from dealings in property;*
- (4) Interest;... [more items listed]” [26 USC § 61]*

This is the point at which many tax “experts” err, either by assuming that the “*items*” of income listed constitute “sources” of income, or by assuming that “*from whatever source derived*” means that all of the “*items*” of income listed, *regardless of where they come from*, are subject to the tax. Both of these assumptions are provably incorrect. (The difference and relationship between “items” and “sources” will be explained below.)

### 3) English vs. Legalese

In our system of written law, Congress may use a term to mean almost anything, as long as the law itself defines that meaning. When the written law explains the meaning of a term used in the law Standard English usage becomes *irrelevant*. For example, by the definition in 26 USC § 7701(a)(1), the term “*person*” includes estates, companies and corporations (in addition to individuals). While no one would call WalMart a “person” in everyday conversation, WalMart *is* a “person” under federal tax law. The legal use of a term is often quite different from basic English, and therefore reading one section of the law alone can be very misleading.

For example, 26 USC § 5841 states that “[t]he Secretary [of the Treasury] shall maintain a central registry of all firearms in the United States which are not in the possession or under the control of the United States.” But this law has a far more limited application than this section by itself would seem to imply. In 26 USC § 5845(a) it is made clear that the term “*firearm*” in these sections does *not* include the majority of rifles and handguns (while the term “firearm” in basic English obviously would), but *does* include poison gas, silencers and land mines.

The average citizen reading the law will naturally tend to assume that he already knows what the words in the law mean, and may have difficulty accepting that the *legal* meaning of the words used in the law may bear little resemblance to the meaning that those words have in common English. Reading the phrase “*all firearms*” in Section 5841 in a way that *excludes* most rifles and handguns is contrary to instinctive reading comprehension, but any lawyer reviewing Sections 5841 and 5845 would confirm that such a reading would be absolutely correct. Reading one section of the law without being aware of the *legal* definitions of the words being used can give an entirely incorrect impression about the application of the law.

As demonstrated, sometimes the apparent meaning of a simple phrase in the law is very different from the legal meaning. The “income tax” is imposed on “*income from whatever source derived*.” If the law did not explain what constitutes “sources of income,” then the law would be interpreted using basic English. However, the law *does* explain what the term means, and therefore standard English usage is irrelevant.

### 4) Sources of Income

To 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 *all three* major printings of Title 26 (the “*United States Code*,” the “*United States Code Annotated*,” and the “*United States Code Service*”), Section 61 *itself* has cross-references similar to the following:

*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” to mean “*all income from whatever source derived*” specifically refers to 26 USC § 861 regarding income from “sources” *within* the United States (and refers to 26 USC § 862 regarding income sources outside of the United States). 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 is specifically dealt with by Section 861, and “*determination*” of sources of income is also dealt with by Section 861 and the following sections.

(It should be mentioned that neither the cross-references nor the indexes are technically the law, but they are indications of how the law works. Unless someone wants to claim that they are *incorrect*, they are still useful indicators. And, as will be shown, they are not necessary for proving the relevance of 26 USC § 861 anyway.)

Numerous sections of the law (e.g. 79, 105, 410, 414, 505) 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).*”

Clearly 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 within income from “sources” *within* the United States. (Section 862 deals within from “without” (outside) the United States.)

Not surprisingly, Section 861 is entitled “*Income from sources within the United States,*” and the first two subsections are entitled “*Gross income from sources within United States*” and “*Taxable income from sources within 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. While the Index of the *statutes* (USC) is not technically the law (as mentioned above), the law does require that a “*general index to the entire Code of Federal Regulations shall be separately printed and bound*” (44 USC § 1510). The courts have stated that publishing a regulation in the Federal Register “*makes it effective against the world,*” but added that without the “*retrieval mechanism provided by an adequate index,*” individuals might not be able to find the rules which apply to them, so Congress required the index. The purpose for this requirement was to “*eliminate secret law*” (580 F.2d 1166 (3rd Cir., 1978)).

The reason this is important is that 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 Code of Federal Regulations, *including the Index*, is the official notification to the public of what the law requires.

Regarding “*determination of sources of income*,” and “*income from sources inside or outside U.S.*,” the Index refers the reader to 26 CFR § 1.861-1 and following, which are the regulations corresponding 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 “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 general 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.*”

(In “26 CFR § 1.861-1” 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*.)

The above quote from the regulations (26 CFR § 1.861-1) also refutes the common but incorrect position that the “*items*” of income listed in Section 61 are “*sources*,” since Section 61 obviously does not “*determine the sources of income for purposes of the income tax.*”

(There is a chart at the end of this report which outlines Part I of Subchapter N and related regulations, and shows the location and context of 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 the related regulations are not about the income of United States citizens living and working exclusively within the United States.

## 5) Determining Taxable Income

In addition to the fact that Section 861 and following, and related regulations, determine what is considered a “*source*” of income subject to the income tax, the regulations also repeatedly

state that these are also the specific sections to be used to ***determine*** “*gross income*” and “*taxable income*” from sources within and/or without the United States.

*“Rules are prescribed for determination of gross income and taxable income derived from sources within and without the United States, and for the allocation of income derived partly from sources within the United States and partly without the United States or within United States possessions. §§ 1.861-1 through 1.864. (Secs. 861-864; ’54 Code.)”* [Treasury Decision 6258]

The sections which are specifically for determining *taxable* income from sources *within* the United States are 26 USC § 861(b) of the statutes, and the corresponding regulations found at 26 CFR § 1.861-8. (The regulations under Section 63, the section defining “*taxable income*,” do *not* explain how to determine taxable income.)

While the relevance of these sections may quickly become obvious, the repeated documentation is important since most tax professionals are already aware that these sections are *not* about the income of most Americans.

Section 861(b) (as mentioned above) is entitled “*Taxable income from sources within United States.*” This section states that taxable income from sources within the United States is the gross income described in 861(a) minus allowable deductions. The regulations under Section 861 state (in the first paragraph):

*“The statute provides for the following three categories of income:*

*(1) Within the United States. The gross income from sources within the United States... See Secs. 1.861-2 to 1.861-7, inclusive, and Sec. 1.863-1. The taxable income from sources within the United States... shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), [allowable deductions]. See Secs. 1.861-8 and 1.863-1.”* [26 CFR § 1.861-1(a)(1)]

(The other two categories of income are income from “*without*” (outside of) the United States, dealt with by Section 862 and related regulations, and income from sources partly within and partly without the U.S., dealt with by Section 863 and related regulations.)

As the above citation states, “gross income” from *sources within* the U.S. are dealt with by 861(a) of the statutes and 1.861-2 through 1.861-7 of the regulations. Taxable income is determined by 861(b) of the statutes, and the corresponding regulations in 1.861-8. These regulations are predictably entitled “*Computation of taxable income from sources within the United States and from other sources and activities,*” and begin by saying the following:

*“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.”*

[26 CFR § 1.861-8]

In the regulations under Section 863 (concerning income from sources inside and outside the U.S.), the following is stated:

*“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.”* [26 CFR § 1.863-1(c)]

(The vast majority of tax professionals ***do not use these sections*** to determine taxable income from sources within the United States. At this point, the average citizen reading this report may guess that there must be some “context” or some other section, or something *somewhere* which would justify the tax professionals blatantly disregarding and disobeying the clear language used in the citations shown above. There is not.)

Note that sections 1.861-8 and following of the regulations are identified as the sections “*for determining taxable income from sources within the United States,”* as well as being the sections to be used whether the income is from sources within *or* without the United States. A similar structure occurs in the regulations under Section 862:

*“(b) Taxable income. The taxable income from sources without the United States... shall be determined on the same basis as that used in Sec. 1.861-8 for determining the taxable income from sources within the United States.”* [26 CFR § 1.862-1]

Section 1.863-6 of the regulations (dealing with income from foreign countries or federal possessions) also identifies sections 1.861-1 through 1.863-5 as applying “[t]he principles... for determining the gross and the taxable income from sources within and without the United States.” Over and over again it is shown that **26 USC § 861(b)** of the statutes and **26 CFR § 1.861-8** of the regulations are to be used to determine taxable domestic income.

## 6) Specific Sources

Section 861 of the statutes uses general language that at first seems to apply to almost all income coming from within the United States.

*“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...*

*(3) Personal services*

*Compensation for labor or personal services performed in the United States; except... [other items listed]”* (26 USC § 861(a))

As with Section 61, it is easy to falsely conclude that these items are always taxable, but the regulations related to Section 861 prove this to be incorrect. (And, as will be shown later, the older regulations and statutes make the correct application of the law crystal clear.)

The regulations in Section 1.861-8 begin by saying that Section 861(b) of the statutes describes “*in general terms*” how to determine taxable income from sources within the United States. However, these same regulations show that the general “within”/“without” rules found in the statutes of Section 861 and following are about income derived from “*specific sources*.”

“(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.*” [26 CFR § 1.861-8(f)(3)(ii)]

In the first paragraph of Section 1.861-8 of the regulations (the section “*for determining taxable income from sources within the United States*”), it is again made clear that the section applies only to the listed “*items*” of income when derived from “*specific sources*.”

“*The rules contained in this section apply in determining taxable income of the taxpayer from specific sources and activities...*” [26 CFR § 1.861-8(a)]

Again, a few paragraphs later, in defining the term “*statutory grouping*,” these regulations again state that taxable income must come from a “*specific source*.”

“[T]he term ‘*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...” [26 CFR § 1.861-8(a)(4)]

In 26 CFR § 1.861-8(f)(1) it is again made clear that Section 1.861-8 (the section “*for determining taxable income from sources within the United States*”) is applicable only to income derived from “*specific sources*.”

“[T]he determination of taxable income of the taxpayer from specific sources or activities and which gives rise to statutory groupings [see previous citation] to which this section is applicable...” [26 CFR § 1.861-8(f)(1)]

From these it is clear that the phrase “*whatever source*” as used in Sections 61 does not simply mean any activity from which income is derived. (If it did, there would be no need for Section 861 and following, and related regulations, to “*determine the sources of income for purposes of the income tax*.”) The following citations show that Section 1.861-8(f)(1) lists the “*specific sources*” of income subject to the income tax.

Again, the first paragraph of 26 CFR § 1.861-8 states the following (the meaning of “*operative section*” will be explained below):

“*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.*” [26 CFR § 1.861-8(a)(1)]

The definition of “*statutory grouping*” (mentioned above) also refers to “*paragraph (f)(1)*” as the list of “*specific sources*.”

“[T]he term ‘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.)” [26 CFR § 1.861-8(a)(4)]

The regulations twice identify “paragraph (f)(1) of this section” (26 CFR § 1.861-8(f)(1)) as the list of specific sources. Paragraph (f)(1) itself confirms this again, and then lists the “specific sources” subject to the income tax:

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

- (i) Overall limitation to the foreign tax credit...
- (ii) [Reserved]
- (iii) DISC and FSC taxable income... [international and foreign sales corporations]
- (iv) Effectively connected taxable income. Nonresident alien individuals and foreign corporations engaged in trade or business within the United States...
- (v) 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...
  - (B) The amount of foreign mineral income...
  - (C) [Reserved]
  - (D) The amount of foreign oil and gas extraction income...
  - (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 [this involves American individuals and companies receiving most of their income from within federal possessions];
  - (F) The exclusion for income from Puerto Rico for residents of Puerto Rico...
  - (G) [deals with Virgin Island tax credits]
  - (H) The income derived from Guam...
  - (I) The special deduction granted to China Trade Act corporations...
  - (J) [deals with foreign corporations]
  - (K) [deals with insurance income of foreign corporations]
  - (L) The international boycott factor...
  - (M) [deals with the Merchant Marine Act of 1936].” [26 CFR § 1.861-8(f)(1)]

None of these “sources” apply to United States citizens who live and work exclusively within the United States. (Federal “possessions,” such as Guam, Puerto Rico, etc., are considered to be *outside* of the United States for income tax purposes.) This is the list of “specific sources” to which Part I of Subchapter N applies, and Part I and its regulations “determine the sources of income for purposes of the income tax” (26 CFR § 1.861-1).

The next subsection (1.861-8(g)) gives examples about how 26 CFR § 1.861-8 works, and states that “[i]n 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)*,” again showing that there ***must*** be some “operative ***section***” (describing some “specific source”) in order for there to be ***taxable*** income.

So, to review, the sections which “***determine the sources of income for purposes of the income tax***” (namely, 861 and following and related regulations) only show income to be taxable when it derives from the “*specific sources*” listed in 26 CFR § 1.861-8(f)(1). Most people do ***not*** receive income from these “*sources of income for purposes of the income tax*,” and most people do not, therefore, receive “*income from whatever source derived*” (the general definition of “*gross income*”), and do not receive “*taxable income from sources within the United States*.”

## 7) **Operative Sections**

The earlier sections of Title 26 (namely ***26 USC § 61*** and following) deal with “items” of *income* that may be taxable (such as compensation for services). However, these sections do not specify where the transaction is taking place, or who is receiving the income. Obviously not everyone on earth who receives “compensation for services” is taxable under U.S. law. A separate part of the law, found in Subchapter N, deals with what types of commerce generate taxable income.

Subchapter N is entitled “*Tax based on income from sources within or without the United States*.” As the title suggests, this subchapter explains when income from inside or outside the United States is subject to the income tax. The titles of the five “Parts” of Subchapter N are “*Determination of sources of income\**” (Part I), “*Nonresident aliens and foreign corporations*” (Part II), “*Income from sources without the United States*” (Part III), “*Domestic international sales corporations*” (Part IV), and “*International boycott determinations*” (Part V). (\* See page 88 for more about the title of Part I of Subchapter N.)

Parts II through V are obviously *not* about U.S. citizens who live and work exclusively within the states. The ***statutes*** of Part I of Subchapter N (beginning with 26 USC § 861) give general rules about determining taxable income from “within” (Section 861) and “without” (Section 862) the U.S., but the ***regulations*** thereunder make it clear that these rules apply only to income derived from the activities described throughout the *other* “Parts” of Subchapter N.

“(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.*” [26 CFR § 1.861-8(f)(3)(ii)]

This term “*specific sources*” is used in three other places in the regulations, every one of which specifically refers to taxable activities described in the “operative sections” of the statutes throughout Subchapter N (which are listed in 1.861-8(f)(1) of the regulations). In other words, while the ***regulations*** list the taxable activities all in one place (26 CFR § 1.861-8(f)(1)), the ***statutes*** describe those taxable activities in various sections throughout Subchapter N. The “*specific sources*” listed in the regulations each refer ***specifically*** to sections of the statutes (called “*operative sections*”) describing those activities. For example, item “(iv)” on the list in 1.861-8(f)(1) specifically refers to sections 871(b)(1) and 882(a)(1) of the statutes, which state the following:

*“A nonresident alien individual engaged in trade or business within the United States... shall be taxable as provided in section 1...” [26 USC § 871(b)(1)]*

*“A foreign corporation engaged in trade or business within the United States... shall be taxable as provided in section 11[\*]...” [26 USC § 882(a)(1)]*

(\* *Section 11* imposes the income tax on corporations; *Section 1* imposes it on individuals)

Here the statutes state that these specific activities (or “sources”) may produce taxable income. If an “item” of income (such as *compensation for services*) derives from the activity described in this “operative section,” that income is subject to the income tax. The “*shall be taxable*” phrase would be entirely unnecessary if “*from whatever source derived*” had the broad meaning that the usual (and incorrect) interpretation of the law gives it.

There is no such “*shall be taxable*” phrase or any “*operative section*” for United States citizen living and working exclusively within the 50 states, and the regulations under Section 861 make it clear that the “*items*” of income must derive from a taxable source or activity described in an “operative section” of the statutes in order to be taxable.

The following analogy may help to clarify the matter of “items” of income and “sources” of income. Suppose that there was a law imposing a tax on “Zonkos,” and that the law defined “Zonkos” as “all toys from whatever store derived, including the following toys: plastic cars, dolls, yoyos,” etc. Then the law stated that another section “determines the stores for purposes of the Zonko tax,” and that section listed “Bob’s Toys,” “Toy City,” and “ToyWorld” as “toy stores.”

In this example, there would be two distinct aspects of the term “Zonko”: whether an item is a taxable “toy,” and whether it comes from a taxable “store.” Both criteria would have to be met for it to legally constitute a “Zonko.” For example, a baby bottle bought at ToyWorld would not be a “Zonko” (even though it came from a “store”), if baby bottles are not within the legal definition of “toys.” Also, a doll bought from “Chuck’s Bargain Basement” also would not be a “Zonko” (even though it is a “toy”), as it did not come from something within the legal meaning of “store.” A yoyo from Toyworld *would* be a “Zonko” as it is both a “toy” *and* comes from a “store.”

Similarly, if an “item” of income (such as dividends) does not come from a taxable “source” or activity (such as a foreign corporation doing business within the United States), it does not constitute “gross income.” While the law goes to great length to specify which “items” of income may be included in “gross income,” the other condition must still be met in order for those items to be taxable: they must derive from a taxable “source” or activity under an “operative section” of Subchapter N (as explained in Section 1.861-8(f)(1) of the regulations). (Note that the definition of “*gross income*” includes both criteria: “*all income from whatever source derived.*”)

## 8) Summary of Current Law

The current statutes and regulations show the correct, limited application of the “income tax” imposed by 26 USC § 1, which is in conflict with what the public generally believes regarding the matter. To summarize,

- *26 USC § 1* imposes the income tax on “taxable income.”
- *26 USC § 63* defines “taxable income” generally as “gross income” minus deductions.
- *26 USC § 61* defines “gross income” generally as income “*from whatever source derived.*”
- *26 USC §§ 861 - 865* and related regulations determine the taxable “sources of income.”
- *26 CFR § 1.861-8* (together with the various statutes of Subchapter N) shows that the taxable “sources of income” apply only to those engaged in international or foreign commerce (including commerce within federal possessions).

## 9) Taxing Power

While the current statutes and regulations document the limited application of the federal income tax, it is important to explain the reason *why* such a limit exists. Without an explanation of *why* the law is as it is, the conclusion may be unbelievable to some (regardless of the actual evidence). Certainly the limitation was not due to Congress not *wanting* to tax all income. Without some limit to Congress’ power, the tax which most people now believe exists (a tax on the income of most Americans) would certainly have been imposed.

According to the Supreme Court, the broad and general wording which Congress used to define “gross income” was intended to tax all income within their power to tax.

*“This Court has frequently stated that this language [defining “gross income”] was used by Congress to exert in this field ‘the full measure of its taxing power.’ ”*

[Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)]

This ruling is speaking specifically of Section 22(a) of the Internal Revenue Code of 1939, which is the predecessor to the current 26 USC § 61. Congress has stated that the scope of “gross income” did not change when the law was rearranged and reworded in 1954. (It should be mentioned that the current tax code is basically just the income tax of 1913, but with many amendments over the years adding, removing, rewording, and renumbering various sections. The fundamental nature of the tax remains the same.)

The general language of the definition of “gross income” (past and present) may give an initial impression of an unlimited tax on the income of every individual. However, the meaning of a statute passed by Congress is limited to those matters which the Constitution puts under federal jurisdiction.

*“It is elementary law that every statute is to be read in the light of the constitution. However 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)]

(Notice that this is not some radical decision, but is considered “elementary law.”)

In other words, a statute may be more restricted than its general wording suggests. The above case goes on to say that Constitutional restrictions are to be *assumed* when reading a statute (state or federal), even though they are not stated.

*“So, although general language was introduced into the statute of 1871, it is not to be read as reaching to matters in respect to which the legislature had no constitutional power, but only as to those matters within its control. And, if there were, as it seems there were, certain special taxes and dues, which, under the existing provisions of the state constitution, could not be affected by legislative action, the statute is to be read as though it in terms excluded them from its operation.”*  
 [McCullough v. Com. Of Virginia, 172 U.S. 102 (1898)]

So a federal statute is to be read as though it specifically excludes matters which the Constitution does not put under federal jurisdiction. So while, as the Supreme Court said, Congress intended to use the “*full measure of its taxing power*” by using such a generally-worded definition of “*gross income*,” the Supreme Court also admits that the income tax “*cannot be applied to any income which Congress has no power to tax*” [William E. Peck & Co. v. Lowe, 247 U.S. 165 (1918)].

So the general wording must be interpreted in light of the Constitutional limits on Congress’ power. But this could pose a problem for the average citizen. How is he to know what the Constitutional limits are on Congress’ power (when even federal judges disagree with each other on the matter)?

As mentioned at the beginning of this report, the Secretary of the Treasury is empowered (by statute) to implement and interpret the law. When the Treasury regulations are published in the Federal Register, they become the official notice to the public of what the law requires. Therefore while the *statutes* may use general language (which might at first glance seem to include matters outside of federal jurisdiction), the *regulations* must give specifics.

Though it is phrased somewhat differently than the current 26 USC § 61, the definition of “gross income” found in Section 22(a) of the 1939 Code appears all-encompassing. The regulations under the 1939 Code, however, are very telling. (The term “net income” was used back then, instead of “taxable income.”)

*“Sec. 29.21-1. Meaning of net income. The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law... enter into the computation of net income as defined by section 21.”*

The term “**fundamental law**” refers to the **Constitution** (as countless court rulings show). While the general wording of the statutes makes no such reference, here the regulations imply that some income **not** exempted by statute is nonetheless **exempt from taxation under the Constitution**.

Note the distinction between income exempted by *statute*, and income exempted by the *Constitution*. This occurs again later in the same section:

“(b) *Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)*”

Again, the regulations are admitting that some things **not** exempted by any **statute** are nonetheless **exempt from taxation**. The above citation refers us to Section 22 (of the 1939 Code) for the meaning of “gross income.” The regulations under that section begin as follows:

“*Sec. 29.22(a)-1. What included in gross income.*

*Gross income includes in general [items of income listed] derived from any source whatever, unless exempt from tax by law. (See section 22(b) and 116.)*”

This refers the reader to Section 22(b) to learn what income is “exempt from tax.” After saying that certain items are specifically exempted by *statute*, the regulations under section 22(b) state:

“*No other items are exempt from gross income except (1) those items of income which are, under the Constitution, not taxable by the Federal Government; (2) those items of income which are exempt from tax on income under the provisions of any Act of Congress still in effect; and (3) the income exempted under the provisions of section 116.*”

Again the regulations explicitly state that some income is not constitutionally taxable, even though it is **not** specifically exempted by any statute passed by Congress. The *statutes* need not mention this, because (as shown above), the Constitutional limitations are to be **assumed** when reading any statute. But because the **regulations** must give specifics, the fact that some income not exempt by statute is exempted by the Constitution is specifically stated in the regulations.

(Many tax professionals are at a loss to explain this. They are unable to identify anything which is *not* taxable under the constitution, but which is *not* exempted by *statute*. While they may know of some things which are not constitutionally taxable (such as certain income of state governments), those things are already exempted by statute (such as 26 USC § 115).)

## 10) **Constitutional Limits**

At this point it is reasonable to consider what types of income might be (as the older regulations state) “*under the Constitution, not taxable by the Federal Government.*” While the public seems largely ignorant of this fact, Congress has legal power over only those few

matters which the Constitution puts under federal jurisdiction (and the Tenth Amendment clearly states this).

Within the 50 states, Congress has legal control over only those matters listed in Article I, Section 8 of the Constitution.

*“We start with first principles. The Constitution creates a Federal Government of enumerated powers. See U.S. Const., Art. I, § 8. As James Madison wrote, “[t]he powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite.”* [United States v. Lopez, 514 U.S. 549 (1995)]

In the 1995 case cited above, the Supreme Court threw out the first “Gun Free School Zone” law (a law forbidding individuals from possessing firearms near schools) as unconstitutional, on the grounds that it was outside of Congress’ enumerated powers described in Article I, Section 8 of the Constitution. Not only did the court say this, but the lawyers on the *other* side tried to argue that the law was about regulating “interstate commerce” (which Article I, Section 8 puts under federal jurisdiction), demonstrating that they *agreed* that the law had to be based on something in Article I, Section 8.

Article I, Section 8 *does* include the “*power to lay and collect taxes,*” but does not say *what* may be taxed by Congress. This allows for two options. The first option is that there are *no* limitations on what Congress can tax (though there are certain rules on *how* “direct” and “indirect” taxes must be imposed). The problem with this option is that it would essentially negate the entire Constitution, as this option would give Congress the jurisdiction and power to control *anything and everything*, provided it exerted that control through tax legislation. For example, if this option were true, in response to the Lopez decision mentioned above, Congress could simply impose a \$1,000,000 “tax” on possessing a firearm near a school, to get around the constitutional restriction that would otherwise exist.

The Supreme Court agreed that this option cannot be. The court said that they could not allow Congress to control by tax legislation matters which they have no jurisdiction to *regulate*. (Congress was attempting, in the following case, to control “child labor” within the 50 states through tax legislation.) The Supreme Court said the following:

*“Grant the validity of this law, and all that Congress would need to do, hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the Tenth Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a socalled tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.”* [Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922)]

In the same year, the court also ruled on the Future Trading Act, which imposed a tax “on all contracts for the sale of grain for future delivery.” The court quoted the citation above, and immediately afterward said this:

*“This has complete application to the act before us, and requires us to hold that the provisions of the act we have been discussing 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)]

Clearly the court saw that Congress’ power to lay and collect taxes does *not* grant unlimited jurisdiction over everything within the states. To ignore the limits of federal jurisdiction when reading the taxation clause would lead to concluding that Congress can control *everything* by tax legislation. (In fact, this reading would also mean that Congress has the power to tax everyone in China, since the taxing clause does not mention *geographical* jurisdiction either.)

The second option is that “*the power to lay and collect taxes*” is limited to matters *otherwise* under federal jurisdiction. For example, Article I, Section 8 specifically puts international commerce under federal jurisdiction, and Article IV, Section 3 gives Congress control of federal possessions. However, “intrastate” commerce (commerce that happens entirely within a single state) is *not* under federal jurisdiction. So the power to tax, together with the clauses giving Congress jurisdiction over international commerce, and commerce within federal possessions, would give Congress the power to tax income from international commerce, and income from federal possessions.

The Supreme Court made an interesting comment in 1918 related to this. The case concerned the income tax act of 1913 (which is the basis of the current tax), and how it applied to a domestic corporation in the business of buying things in the states and selling them in *foreign* countries. The corporation was arguing that the tax in this case violated the provision of the Constitution which forbids the federal government from taxing exports from any state. The Court stated the following:

*“The Constitution broadly empowers Congress not only ‘to lay and collect taxes, duties, imposts, and excises,’ but also ‘to regulate commerce with foreign nations.’ So, if [the clause forbidding taxes on exports from states] be not in the way, Congress undoubtedly has power to lay and collect such a tax as is here in question.”*

[William E. Peck & Co. v. Lowe, 247 U.S. 165 (1918)]

In other words, if not for the question about whether this was a tax on state exports, this income would be taxable because Congress is given the general power “*to lay and collect taxes,*” and is specifically given the power to “*regulate commerce with foreign nations.*” The court obviously thought the second clause was relevant to whether Congress could tax such income.

The courts have long argued over the concept that “the power to tax is the power to destroy,” meaning that the ability to tax something implies the ability to regulate it or to forbid it entirely. This conversely implies that if a government has no jurisdiction to *regulate* or *forbid* an activity, then it also has no jurisdiction to *tax* that activity. There are numerous Supreme Court cases dealing with the concept.

*“[N]o state has the right to lay a tax on interstate commerce in any form... and the reason is that such taxation is a burden on that commerce, and amounts to a regulation”*

*of it, which belongs solely to congress. This is the result of so many recent cases that citation is hardly necessary.” [Leloup v. Port of Mobile, 127 U.S. 640 (1888)]*

In this case the court is stating the restrictions on what a *state* government can tax, but the underlying logic is clear. Taxing commerce is a burden on that commerce, and amounts to a *regulation* of commerce. While Congress is authorized to regulate *interstate* commerce (commerce crossing state lines) and international commerce, it has no jurisdiction over *intrastate* commerce (commerce occurring entirely within a single state). By the simple logic above, that means Congress cannot tax income from intrastate commerce.

*“No interference by Congress with the business of citizens transacted within a state is warranted by the Constitution, except such as is strictly incidental to the exercise of powers clearly granted to the legislature.” [License Tax Cases, 72 U.S. 462 (1866)]*

It is true that the opinions of the courts have fluctuated significantly on this, from saying that the power to tax requires the power to regulate, to saying that Congress may tax things it cannot regulate, provided that taxation does not amount to *regulation* under the guise of a “tax.”

The courts have also upheld various “excise” taxes on certain activities and articles, even though the transactions may happen within a single state. But that is a far cry from claiming that “making a living” within the 50 states can be the subject of a federal excise tax. Considering the massive “social engineering” in the income tax laws, punishing some behaviors and rewarding others, it would be difficult to argue that it would not constitute an attempt to regulate behavior.

One would be hard-pressed to find any provision in the Constitution justifying an attempt by Congress to require most Americans to subject all of their financial records to inspection by the federal government. In addition, within the 50 states Congress does not have general jurisdiction to reward and punish personal decisions. But for those who receive taxable income, the tax code rewards behaviors such as adopting children (26 USC § 23), having a mortgage (26 USC § 25), paying college tuition (26 USC § 25A), producing alternative fuels (26 USC § 29), using an electric car (26 USC § 30), employing Indians (26 USC § 45A), etc. (At the same time, the Code “punishes” other choices, such as getting married, or being too successful.)

In short, *if* the income of most Americans *was* subject to the federal income tax, Congress would have managed to “*enact a detailed measure of complete regulation of [their personal choices] and enforce it by a so-called tax upon departures from it.” But “[t]o give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.”*

(These are the words of the Supreme Court from the case of Bailey v. Drexel Furniture Co. (259 U.S. 20).) Congress cannot acquire such power within the 50 states, simply by passing such a law in the form of *tax* legislation. (Because the tax only applies to those engaged in certain international or foreign commerce, all the rewards and punishments in the Code are

limited to those who *are* under federal jurisdiction; Congress is simply regulating matters which the Constitution gave them power over.)

Regarding the federal income tax, the courts' position on the matter is ultimately *irrelevant*. Regardless of what the courts think Congress *could* have taxed, the *statutes and regulations* show what Congress *did* tax. Whether the courts think Congress has the constitutional power to tax the income of all Americans is only relevant if Congress attempts to *impose* such a tax, which has not occurred. (The courts cannot expand the scope of a tax just by saying that Congress *could* have taxed more if they had wanted to.)

Brief mention should be made of the 16th Amendment to the Constitution, since there is a common but erroneous belief that the 16th Amendment expanded Congress' power to tax incomes. The purpose of the 16th Amendment, according to the Supreme Court in *Brushaber v. Union Pacific* (240 U.S. 1), and again in *Stanton v. Baltic Mining* (240 U.S. 103) was to make it clear that the income tax is, and has always been, an indirect "excise" tax, which never required "apportionment" (a cumbersome process required for all "direct" taxes, in which the tax is divided up among the states according to populations). The Secretary of the Treasury agreed with the Court in Treasury Decision 2303.

*"The provisions of the sixteenth amendment conferred no new power of taxation, but simply prohibited [Congress' original power to tax incomes] from being taken out of the category of indirect taxation, to which it inherently belonged, and being placed in the category of direct taxation subject to apportionment."* [Treasury Decision 2303]

An in-depth explanation of direct and indirect taxes, and how they must be imposed, is not necessary here. The only relevant point is that Congress' taxing jurisdiction was *not* expanded by the 16th Amendment.

*"As pointed out in recent decisions, [The Sixteenth Amendment] does not extend the taxing power to new or excepted subjects..."* [Peck v. Lowe, 247 U.S. 165 (1918)]

## 11) Exempt Income

The above issue of Constitutional limits on Congress' taxing power is *not* intended to dispute the constitutionality of the income tax. In fact, the opinion of this author, the readers, and even the courts regarding the question of taxing jurisdiction ends up being irrelevant in this case. The statutes of Congress, together with the regulations of the Secretary of the Treasury (which must also be approved by Congress), show that they believed their ability to tax income was limited to those involved in international and foreign commerce.

As discussed above, the regulations under 22(a) of the 1939 Code show that the meaning of "gross income" does not include income which is exempt by statute, or other income which is "*under the Constitution, not taxable by the Federal Government.*"

But, as stated before, the regulations must *specifically* inform the public of what is required, rather than leaving people to *guess* at what is Constitutionally taxable. The following is the first paragraph of the 1945 regulations under the section of statutes defining "gross income":

*“39.22(a)-1 What included in gross income (a) Gross income includes in general [items of income listed] derived from any source whatever, unless exempt from tax by law. See sections 22(b) and 116. [the regulations under the cited section states that some income not exempted by statute is “under the Constitution, not taxable by the Federal Government”] In general, income [not “gross income”] is 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. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.”*

The regulations have made similar statements at least back to 1922.

*“Art. 31. What included in gross income.--Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law... Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens by section 217 and for citizens and domestic corporations deriving at least 80 per cent of their gross income from sources within possessions of the United States by section 262.”* [Article 31, Regulations 62 (1922)]

*“Art. 71. What excluded from gross income.--Gross income excludes the items of income specifically exempted by the statute and also certain other kinds of income by statute or fundamental law free from tax.”* [Article 71, Regulations 62 (1922)]

Keeping in mind the matter of taxing jurisdiction, it becomes clear that the Secretary of the Treasury in these regulations was informing the public of which matters are constitutionally taxable by the federal government. This list of taxable activities was completely absent from the statutes defining “gross income” (in 1921 and 1939). As the Supreme Court has stated, ***“the statute is to be read as though it in terms exclude[s]”*** matters not within the constitutional power of the government to tax. At the same time, the ***regulations must specifically inform the public of what the law requires***, and they did. Not surprisingly, the list of taxable activities in these regulations matches precisely those matters which the Constitution puts under federal jurisdiction (international and foreign commerce, and commerce in federal possessions).

Anyone claiming that this list of taxable activities is ***not*** exclusive (claiming instead that other types of income are also taxable) encounters several logical problems. For example, one must then claim that the regulations specifically *say* that some income not exempt by statute is exempt under the Constitution, but that those regulations never give any indication as to *what* income is meant. If this list is *not* the explanation of what is constitutionally taxable, then no

further explanation seems to exist (which would violate the requirement that the regulations specifically state what the law requires).

In addition, one would be hard pressed to explain *why* these regulations bother to specifically point out these taxable activities (when the statutes do not), if this is not a complete list of what the Secretary believed to be constitutionally taxable.

While the regulations specifically mention the Constitutional limitations, and the *limits are to be assumed* when reading the statutes, this is *not* to say that the statutes give no indication of the limited nature of the tax. While the general statutory definition of “gross income” by itself may be misleading, there is plenty of evidence in the statutes that shows that Congress knew the limits of its power, and stayed within those bounds.

Most notably, the entire structure and contents of Subchapter N (“*Tax based on income from sources within or without the United States*”) indicates that it is about international and foreign commerce. In that subchapter, Congress specifically enumerates the activities that are subject to the tax. Blindly *assuming* that the tax includes income from other activities is contrary to established law.

*“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.”*

[Gould v. Gould, 245 U.S. 151 (1917)]

While there are some complicated rules about various foreign tax credits, federal possessions, etc., the statutes and regulations, past and present, show that there are only three general situations in which there can be “taxable income” subject to the federal income tax:

- 1) **Foreigners** receiving income from within the United States.
- 2) Citizens of the United States receiving **foreign** income.\*
- 3) U.S. corporations receiving most of their income from within federal possessions, technically “**foreign**” to the 50 states, who are then taxed on their income from within the states (see 26 USC § 936). (Before 1986, 26 USC § 931 also applied this “benefit” to individual U.S. citizens.)

(\* Some evidence suggests that only “*foreign earned income*” of citizens is taxable under this category, meaning the citizen must physically be *outside* of the United States earning the income (see 26 USC § 911), while other evidence suggests that *foreign* source income of citizens living and working *within* the United States could also be taxable.)

## 12) **Intent to Deceive**

Following the current statutes and regulations, and arriving at the conclusion that most Americans do not receive taxable income, admittedly can be a somewhat complicated task (particularly for those unaccustomed to reading law). While the evidence speaks for itself,

there is another factor that needs to be addressed to give credence to the conclusions of this report.

The taxable sources of income are listed in a portion of the regulations entitled “miscellaneous matters,” buried deep in a confusing jumble where most tax professionals have never looked. Regardless of how solid the citations are supporting the conclusion of this report, such a claim cannot be credibly made without also openly accusing the authors of the law of making a concerted effort to deceive the public. It would be absurd to claim that a law that is this difficult to decipher came about purely by accident. At the same time, an accusation that the lawmakers set out to defraud the public certainly requires supporting evidence. Such evidence is abundant.

There are many matters discussed previously in this report which would suggest an attempt to deceive. Did the authors not know that the phrase “*from whatever source derived*” would be read by most as meaning “no matter where it comes from”? Is it coincidence that the taxable “items” are listed near the very beginning of the law, but the taxable “sources” are not described until several *thousand* pages later?

How did it happen that the list of taxable sources ended up under the unobtrusive heading “miscellaneous matters” in the regulations found in **26 CFR § 1.861-8(f)(1)**? If the goal of the lawmakers was to convey the truth, the current statutes and regulations would not have been the result. The following is intended to expose efforts to conceal the truth, while having the law remain literally correct, as it must be.

Reviewing a situation at various points in time can be more informative than simply looking at the situation from one point in time. For example, if the license plate of a stolen car (but not the car itself) is found in a garage, that may not be conclusive evidence of a crime. However, a series of pictures taken over a few days can be very telling: an empty garage one day, a car fitting the description of the stolen car in the garage the next day, a welding machine next to the car the next day, pieces of a car there the next day, etc.

Similarly, looking at “snapshots” of certain parts of the law at different times, seeing how they were reworded, rearranged, etc., can give a clearer picture of this deception. While the current statutes and regulations certainly indicate intent to deceive, a longstanding and ongoing attempt to cover up the truth becomes apparent when tracing the law backwards in history.

### **13) Cover-Up of 1954**

In 1954, the Code (the income tax statutes) underwent a major rearranging and renumbering (and to some extent, rewording). This change-over did not substantially change the law itself, but simply rearranged it. While there have been various amendments, the current Code retains the same general structure, numbering and content of the 1954 Code.

At the time of the 1954 “transformation” of the Code, several changes helped to conceal the truth about the limited application of the federal income tax.

As shown above, the regulations in 1945 specifically stated (twice) that some income not exempt by statute was nonetheless exempt from federal taxation because of the Constitution. The 1945 regulations under the definition of “gross income” began as follows:

*“Sec. 29.22(a)-1. What included in gross income.*

*Gross income includes in general [items of income listed] derived from any source whatever, unless exempt from tax by law.” [1945 regulations]*

Those regulations then went on to explain that this refers to income exempt by statute or “*fundamental law*,” meaning the Constitution. The current corresponding regulations begin in a similar manner:

*“Sec. 1.61-1 Gross income. (a) General definition. Gross income means all income from whatever source derived, unless excluded by law.” [26 CFR § 1.61-1]*

However, no mention of the Constitution remains. The phrase “*unless excluded by law*” is now almost universally misunderstood to mean “unless excluded by statute.” The ***Constitutional limitations still apply*** (there have been no subsequent constitutional amendments relative to the taxing power), but the present regulations under **26 USC § 61** do ***not*** explicitly say that this is part of the “law” which exempts certain income. Instead, they use the general wording that leaves the reader free to assume that only income specifically exempted by *statute* is exempt from taxation.

The current regulations do show that some “law” *outside* of Title 26 still exempts some income from taxation.

*“[A] class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is:*

- (i) Wholly excluded from gross income under any provision of Subtitle A, or*
- (ii) Wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law.” [26 CFR § 1.265-1(b)]*

The section goes on to say that “*the term nonexempt income means any income which is required to be included in gross income.” Even here, the specific reference to the Constitution has been removed, allowing the reader to assume that it refers only to exemption by some other *statutory* law (as opposed to the “fundamental law,” the Constitution). The disappearance of the specific reference to the Constitution was only one part of a major shift in the structure of the Great Deception that occurred in 1954. Prior to 1954, the regulations stated that “gross income” included everything not exempt, and then made clear that some types of income were not taxable by the federal government because of the Constitution. The regulations regarding “*What included in gross income*” then went on to say the following:*

*“Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations... and, in certain cases... for citizens and domestic corporations deriving income from sources within possessions of the United States.*”

This list of taxable activities is absent from the current regulations under 26 USC § 61. However, something very similar is found in the current regulations under 26 USC § 861. The regulations under Section 861 twice define the term “*class of gross income*,” saying that a “*class of gross income*” “*may consist of one or more items... of gross income enumerated in section 61.” The regulations in 26 CFR § 1.861-8 then refer the reader to “*paragraph (d)(2) of this section which provides that a class of gross income may include excluded income.”**

In other words, the “*items*” of income listed in Section 61 are not necessarily taxable, but are in some cases “exempt” or “excluded” from the federal income tax. Paragraph (d)(2) states only “[*Reserved*]” (meaning there is no current regulation) but refers the reader to paragraph (d)(2) of the temporary regulations at 26 CFR § 1.861-8T. That section describes what is meant by exempt income.

*“(ii) Exempt income and exempt asset 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.” [26 CFR § 1.861-8T(d)(2)(ii)]*

The section then goes on to specify what is not exempt (i.e. what *is* taxable). The following should be read carefully, since it starts with a double negative. If a certain kind of income is not exempt, it means it is subject to the federal income tax. Therefore, after being told that “*items*” of income (which make up “*classes of gross income*”) are not always taxable, a list is given of the types of income which are subject to the federal income tax:

*“(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...*

*(B) In computing the combined taxable income of a DISC or FSC...*

*(C) ...the gross income of a possessions corporation...*

*(D) Foreign earned income as defined in section 911...*” [26 CFR § 1.861-8T(d)(2)(iii)]

This is the entire list of non-exempt income. The idea that other types of income are also taxable (not exempt), despite not being listed, is contradicted by the regulations stating that paragraph (d)(2) “*provides that a class of gross income [consisting of the “items” of income listed in 26 USC § 61] may include excluded income.” Unless those types of income not listed are exempt, paragraph (d)(2) does not show that the “items” of income listed in Section 61 may be exempt. (A basic principle of law is that such a list is assumed to be exclusive and complete, unless a phrase such as “*including, but not limited to...*” is used.)*

While it is arranged and worded differently, this list of non-exempt income is essentially the same as the regulations under the old statute defining “gross income.” It includes citizens with foreign income, those receiving income from within possessions, and foreigners with U.S. income. But while the 1945 regulations listed these “non-exempt” activities under the regulations defining “gross income,” they are currently buried in dozens of pages of less prominent regulations under 26 USC § 861. So while the 1945 statute and regulation defining “gross income” by themselves indicated the limited application of the law, the trail to find the truth in the current law is more involved (though the end conclusion is the same).

The basic shift in the Great Deception in 1954 can be summed up as this: While the *older* version showed the limitations of the law in “step one” (the definition of “gross income”), the *current* statute and regulation defining “gross income” use the word “source” without further explanation, and *additional* steps must be followed to discover that the meaning of that term (“source”) is determined by 26 USC § 861 and following, and related regulations.

Prior to 1954, the regulations did *not* say that Section 119 (predecessor to the current 861 and following) and its regulations “determined the sources of income for purposes of the income tax.” Instead, the regulations under 22(a) (defining “gross income”) list the *exact same activities* as Section 119 when discussing income from *within* the United States. In effect, both the regulations defining “gross income,” *and* Section 119 and related regulations “determined the sources of income for purposes of the income tax.”

(The older regulations defining “gross income” mention “*nonresident aliens and foreign corporations*” and “*citizens and domestic corporations deriving income from sources within possessions of the United States.*” At the same time the regulations under 119 mention “*nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251.*”)

Prior to 1954, not only did the regulations under the two sections match *exactly*, but there was a *direct link* between Section 22 (predecessor of 61) and Section 119 (predecessor of 861 and following). Section 22(g) of the 1939 statutes read: “*For computation of gross income from sources within and without the United States, see Section 119.*” (As shown above, a similar cross-reference still exists under Section 61 in the three main printings of the Code, referring to Section 861 regarding “*Income from sources within the United States,*” but prior to 1954 the reference was part of the actual *text* of the statutes.)

After 1954, the admission of the limited application of the tax vanished from the regulations defining “gross income,” but the regulations under 26 USC § 861 began to say that 861 and following (and related regulations) “*determine the sources of income for purposes of the income tax.*” This change removed any chance of the regulations under Section 61 raising suspicions.

(The way federal law works there is no requirement that a section which *uses* a term point to where the definition or explanation of that term can be found. As ludicrous as it seems, it would be perfectly legal for Section 1 of some law to impose a tax “on the transfer of each automobile,” and then have Section 14,523(g)(4)(iii) say that “for the purposes of Section 1,

the term ‘automobile’ means a blue Corvette owned by a foreigner.” That is in essence how the Great Deception has been structured since 1954.)

While this makes the truth more difficult (though not impossible) to demonstrate with the current statutes and regulations alone, in retrospect it strongly confirms the limited nature of the tax, by showing that while the structure of the deception has changed, the conclusion remains the same.

But the regulations defining “gross income” were not the only place where the truth became less clear during the 1954 “transformation.” As mentioned above, when the statutes were being rearranged and renumbered, Section 119 of the 1939 Code became Part I of Subchapter N (26 USC § 861 and following). The Senate report on the 1954 Code states the following:

*“SUBCHAPTER N - TAX BASED ON INCOME FROM SOURCES  
WITHIN OR WITHOUT THE UNITED STATES*

*PART I - Determination of Sources of Income*

- § 861. Income from sources within the United States*
- § 862. Income from sources without the United States*
- § 863. Items not specified in section 861 or 862*
- § 864. Definitions*

*These sections, which are identical with sections 861-864 of the House bill, correspond to section 119 of the 1939 Code. No substantive change is made, except that section 861(a)(3) would extend the existing 90-day \$3,000 rule in the case of a nonresident alien employee of a foreign employer to a nonresident alien employee of a foreign branch of a domestic employer.”*

Congress here states that the application of the law *did not change* (except for the specific detail mentioned). As would be expected, the statutes are nearly identical.

*Sec. 119. [1939 Code] Income from sources within the United States*

*(a) Gross Income from Sources in United States.*

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

*Sec. 861. [current Code] 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:...*

Section 119 of the old statutes and Section 861 of the current statutes use general terms that could easily be misread as applying to any income from within the United States. But while the statutes did not change, the clarity of the **regulations** corresponding to these sections changed dramatically. The older regulations admitted the truth so plainly and so often that no step-by-step explanation is needed. The following is the equivalent of the current **26 CFR § 1.861-1, in its entirety**.

*“Sec. 29.119-1. Income from sources within the United States.*

*Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 [this applies only to those who receive a large percentage of their income from within federal possessions] are taxable only upon income from sources within the United States. Citizens of the United States and domestic corporations entitled to the benefits of section 251 are,*

*however, taxable upon income received within the United States, whether derived from sources within or without the United States. (See sections 212(a), 231(c), and 251.)*

*The Internal Revenue Code divides the income of such taxpayers into three classes:*

- (1) Income which is derived in full from sources within the United States;*
- (2) Income which is derived in full from sources without the United States;*
- (3) Income which is derived partly from sources within and partly from sources without the United States.*

*The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.”*

Note that the second paragraph in the older regulations shows that Section 119 of the statutes is for determining taxable income of “*such taxpayers*,” meaning those deriving income from *specific taxable activities*. The general language of the statutes is applicable *only* to those involved in certain types of international and foreign commerce.

The subsequent sections of the older regulations (like the current regulations) then deal with specific “items” of income. The sections of regulations following that (which correspond to the current 26 CFR § 1.861-8) then deal with determining taxable income from sources within the United States. Again, the regulations clearly show the limited application of the law.

*“Sec. 29.119-9. Deductions in general.*

*The deductions provided for in chapter 1 shall be allowed to nonresident alien individuals and foreign corporations engaged in trade or business within the United States, and to citizens of the United States and domestic corporations entitled to the benefits of section 251, only if and to the extent provided in sections 213, 215, 232, 233, and 251.*

*Sec. 29.119-10. Apportionment of deductions.*

*From the items specified in sections 29.119-1 to 29.119-6, inclusive, as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted [allowable deductions]. The remainder shall be included in full as net income from sources within the United States...”*

(There is a chart at the end of this report showing the outline and excerpts from Part I of Subchapter N and related regulations, and another chart showing the outline and excerpts from the corresponding statutes and regulations from before 1954.)

Can it be considered an accident that the current regulations are so overly-complex and confusing, while the older regulations blurted out the truth in plain English in the very first sentence? The fact that the statutes apply only to income from certain “specific sources” (relating to international and foreign commerce) is still stated in the current regulations, but rather than being in the first sentence, it is buried deep in the jumbled mess:

“(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.” [26 CFR § 1.861-8(f)(3)(ii)]

In fact, even here it does not specify to which “*specific sources*” it is referring; the meaning of that term has to be discovered by searching elsewhere in the regulations. (The three other sections of the regulations which use the term “*specific sources*” show that it refers to the taxable activities described in the “operative sections” throughout Subchapter N.) It was clear to whom the regulations prior to 1954 applied. (While many tax professionals are now aware of the correct application of Section 861 and its regulations, it certainly is not evident at first glance.)

When the regulations changed in 1954, they did *not* change directly into what the regulations are today. The current maze of “*statutory groupings*,” “*specific sources*,” “*operative sections*,” etc. did not come about until 1978. Of particular note is how the regulations in 26 CFR § 1.861-8 appeared just after the change in 1954, and how the corresponding regulations appeared prior to 1954. The wording was only very slightly changed, but gives one of the most obvious examples of intent to deceive.

<u>BEFORE 1954</u>	<u>AFTER 1954</u>																								
29.119-10 Apportionment of deductions.	1.861-8 Computation of Taxable Income from Sources Within the United States																								
<p><b><u>From the items specified in sections 29.119-1 to 29.119-6, inclusive, as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. <u>The remainder shall be included in full as net income from sources within the United States.</u></u></b> The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.</p> <p>Example. A <u>nonresident alien individual</u> engaged in trade or business within the United States whose taxable year is the calendar year derived gross income from all sources for 1942 of \$180,000, including there-in:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Interest on bonds of a domestic corporation</td> <td style="text-align: right;">\$9,000</td> </tr> <tr> <td>Dividends on stock of a domestic corporation</td> <td style="text-align: right;">4,000</td> </tr> <tr> <td>Royalty for the use of patents within the United States</td> <td style="text-align: right;">12,000</td> </tr> <tr> <td>Gain from sale of real property [in U.S.]</td> <td style="text-align: right;">11,000</td> </tr> <tr> <td></td> <td style="text-align: center;">-----</td> </tr> <tr> <td>Total</td> <td style="text-align: right;">36,000</td> </tr> </table>	Interest on bonds of a domestic corporation	\$9,000	Dividends on stock of a domestic corporation	4,000	Royalty for the use of patents within the United States	12,000	Gain from sale of real property [in U.S.]	11,000		-----	Total	36,000	<p>(a) General. <b><u>From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, 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 other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. <u>The remainder, if any, shall be included in full as taxable income from sources within the United States.</u></u></b> The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income</p> <p>Example. A <u>taxpayer</u> engaged in trade or business receives for the taxable year gross income from all sources in the amount of \$180,000, one-fifth of which (\$36,000) is from sources within the United States, computed as follows:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Interest on bonds of a domestic corporation</td> <td style="text-align: right;">\$9,000</td> </tr> <tr> <td>Dividends on stock of a domestic corporation</td> <td style="text-align: right;">4,000</td> </tr> <tr> <td>Royalty for the use within the United States of patents</td> <td style="text-align: right;">12,000</td> </tr> <tr> <td>Gain from sale of real property [in U.S.]</td> <td style="text-align: right;">11,000</td> </tr> <tr> <td></td> <td style="text-align: center;">-----</td> </tr> <tr> <td>Total</td> <td style="text-align: right;">36,000</td> </tr> </table>	Interest on bonds of a domestic corporation	\$9,000	Dividends on stock of a domestic corporation	4,000	Royalty for the use within the United States of patents	12,000	Gain from sale of real property [in U.S.]	11,000		-----	Total	36,000
Interest on bonds of a domestic corporation	\$9,000																								
Dividends on stock of a domestic corporation	4,000																								
Royalty for the use of patents within the United States	12,000																								
Gain from sale of real property [in U.S.]	11,000																								
	-----																								
Total	36,000																								
Interest on bonds of a domestic corporation	\$9,000																								
Dividends on stock of a domestic corporation	4,000																								
Royalty for the use within the United States of patents	12,000																								
Gain from sale of real property [in U.S.]	11,000																								
	-----																								
Total	36,000																								

[remainder of example omitted]	[remainder of example omitted]
--------------------------------	--------------------------------

The wording is nearly identical, except for two changes. The phrase stating that the whole section applies *only* to *nonresident aliens* and *foreign corporations* simply *vanished*. In addition, while the specifics of the example in the regulation remained *identical*, the phrase “*a nonresident alien individual*” was replaced with “*a taxpayer*.” As Congress stated, the application of the law *did not change* in 1954, but some key phrases in the regulations were removed to make the truth less obvious. A similar disappearance of a phrase occurred at the same time in the section of regulations dealing with “interest” from the U.S. The wording remained *identical* except for the disappearing phrase.

<u>BEFORE 1954</u>	<u>AFTER 1954</u>
<p>29.119-2. Interest.</p> <p>There shall be included in the gross income from sources within the United States, <b><u>of nonresident alien individuals, foreign corporations, and citizens of the United States, or domestic corporations which are entitled to the benefits of section 251</u></b>, all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except...</p>	<p>1.861-2 Interest.</p> <p>(a) General. There shall be included in the gross income from sources within the United States all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except...</p>

(Interest is the only “item” of income for which the regulations specifically mentioned *who* was receiving it, but the regulations cited above state that in the case of *all* of the “items” of income, the deductions and determination of taxable income can be done only by those engaged in the specific taxable activities.)

#### **14) Other Cover-Ups**

The current income tax is based upon laws that have existed for the better part of a century. Though the original laws, and how they were portrayed to the public, were already deceptive, there are numerous examples, from the beginning of the tax up to today, of things being moved, reworded, renumbered and changed, in such a way to make the correct application of the laws more and more difficult to find.

#### **1921**

As shown above, some very telling phrases simply *vanished* from the regulations in 1954. But it was not only the regulations that lost some honesty along the way. The statutes of the Revenue Act of 1921 show why the regulations said what they said back before 1954. Just as happened with the regulations, a telling phrase that existed in 1921 is no longer found in the

statutes. The current Section 861 and its predecessors have remained basically the same for more than 70 years. The text begins *“The following items of gross income shall be treated as income from sources within the United States:”*

The section then lists certain “items” of income (interest, dividends, compensation for labor, rents and royalties, etc.) coming from inside the United States. In 1921 the section was very similar, but it began *“That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:...”* One was *“entitled to the benefits of section 262”* only if most of his income came from federal *possessions*, such as Guam or Puerto Rico.

(While Section 217 itself mentions only *individuals*, Section 232 of the Act states that *“[i]n the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.”*)

**1921 Code**

**1939 Code**

**Current Code**

<p>Net income of nonresident alien individuals</p> <p>Sec. 217. (a) That <b><u>in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262</u></b>, the following items of gross income shall be treated as income from sources within the United States:</p> <p>(1) Interest...</p> <p>(2) The amount received as dividends...</p> <p>(3) Compensation for labor or personal services performed in the United States.</p> <p>(4) Rentals or royalties...</p> <p>(5) Gains, profits, and income from the sale of real property...</p> <p>-----</p> <p>(b) From the items of gross income specified in subdivision (a) there shall be deducted [allowable deductions]. The remainder, if any, <b><u>shall be included in full as net income from sources within the United States.</u></b></p>	<p>Sec. 119. Income from sources within United States</p> <p>(a) Gross income from sources in United States.</p> <p><i>The following items of gross income shall be treated as income from sources within the United States:</i></p> <p>(1) Interest...</p> <p>(2) Dividends...</p> <p>(3) Personal services - Compensation for labor or personal services performed in the United States...</p> <p>(4) Rentals and royalties...</p> <p>(5) Sale of real property...</p> <p>(6) Sale of personal property...</p> <p>-----</p> <p>(b) Net income from sources in United States</p> <p>From the items of gross income specified in subsection (a) of this section there shall be deducted [allowable deductions]. The remainder, if any, <b><u>shall be included in full as net income from sources within the United States.</u></b></p>	<p>Sec. 861. Income from sources within the United States</p> <p>(a) Gross income from sources within United States</p> <p><i>The following items of gross income shall be treated as income from sources within the United States:</i></p> <p>(1) Interest...</p> <p>(2) Dividends...</p> <p>(3) Personal services - Compensation for labor or personal services performed in the United States...</p> <p>(4) Rentals and royalties...</p> <p>(5) Disposition of United States real property interest...</p> <p>(6) Sale or exchange of inventory property...</p> <p>(7) Amounts received as underwriting income...</p> <p>(8) Social security benefits...</p> <p>-----</p> <p>(b) Taxable income from sources within United States</p> <p>From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted [allowable deductions]. The remainder, if any, <b><u>shall be included in full as taxable income from sources within the United States...</u></b></p>
<p>(c) The following items of gross income shall be treated as income from sources <u>without</u> the United States:...</p> <p>-----</p> <p>(d) From the items of gross income specified in subdivision (c) there shall be deducted [allowable deductions]. The remainder, if any, shall be treated in full as net income from sources <u>without</u> the United States.</p>	<p>(c) Gross income from sources <u>without</u> United States</p> <p>The following items of gross income shall be treated as income from sources <u>without</u> the United States:...</p> <p>-----</p> <p>(d) Net income from sources without the United States - From the items of gross income specified in subsection (c) of this section there shall be deducted [allowable deductions]. The remainder, if any, shall be treated in full as net income from sources <u>without</u> the United States.</p>	<p>Sec. 862. Income from sources <u>without</u> the United States</p> <p>(a) Gross income from sources without United States</p> <p>The following items of gross income shall be treated as income from sources <u>without</u> the United States:...</p> <p>-----</p> <p>(b) Taxable income from sources without United States - From the items of gross income specified in subsection (a) there shall be deducted [allowable deductions]. The remainder, if any, shall be treated in full as taxable income from sources <u>without</u> the United States...</p>
<p>(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States...</p>	<p>(e) Income from sources partly within and partly without United States</p> <p>Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section, shall be allocated or apportioned to sources within or without the United States...</p> <p>(f) Definitions...</p>	<p>Sec. 863. Special rules for determining source</p> <p>(a) Allocation under regulations</p> <p>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...</p> <p>Sec. 864. Definitions and special rules...</p> <p>Sec. 865. Source rules for personal property sales...</p>

Although it is obvious to whom this section applied in 1921, some may question whether this is at all relevant to *current* law. Treasury Decision 8687, in discussing what the *current* regulations under 26 USC § 863 should say, specifically refer to Section 217 of the 1921 Code in trying to determine the “legislative intent” of Congress.

*“The legislative history to section 863's predecessor, section 217(e) of the Revenue Act of 1921, also reflects an intention that...”* [Treasury Decision 8687]

This Treasury Decision, passed in late 1996, confirms that Section 217 of the Revenue Act of 1921 is the predecessor of the current Part I of Subchapter N, and shows that the IRS still refers to the 1921 statutes to determine the proper application of the *current* Code. The Internal Revenue Manual shows that the courts, as well as the IRS, considers legislative history when determining the correct application of the law.

*“The courts give great importance to the literal language of the Code but the language does not solve every tax controversy. Courts also consider the history of a particular code section...”* [Internal Revenue Manual, (4.2)7.2.1.1]

When the tell-tale phrase disappeared from the statutes after 1921, the application of the law did not change. What changed was the effort required to find the truth.

### **1978**

In 1978, the wording of 26 CFR § 1.861-8 was changed significantly, and the title was changed from “**Computation of Taxable Income from Sources Within the United States**” to “*Computation of taxable income from sources within the United States and from other sources and activities.*” Some have suggested that the current title implies that one should not be using this section unless he has income *both* from within the United States *and* from “other sources and activities.” The older title, as well as the text of the current regulations, shows that this is not the case.

In addition to the title change, the section also went from less than *one* page in length to more than *thirty* pages, and a host of new “legalese” terms appeared, including “*operative sections*,” “*statutory groupings*,” “*specific sources*,” etc. There were no significant changes in the statutes in 1978 that would explain this sudden expansion of the related regulations. This sudden explosion in size and complexity of these regulations seems to serve no purpose other than to **confuse matters and obfuscate the truth.**

### **1988**

Prior to 1988, the title of Part I of Subchapter N (which begins with Section 861) was “*Determination of sources of income*” (which is still the heading of the related regulations). In 1988, this title was changed in the Government Printing Office version of the Code to “*Source rules and other general rules relating to foreign income.*”

“1988 - *Pub. L. 100-647, title I, Sec. 1012(h)(2)(D), Nov. 10, 1988, 102 Stat. 3503, substituted “Source rules and other general rules relating to foreign income” for “Determination of sources of income” in item for part I.*” [Notes under Subchapter N]

Interestingly, the “*United States Code Service*” version of the Code still shows the title to be “*Determination of sources of income.*” The USCS version of the Code tries to stay true to the original laws, or “*Statutes at Large,*” thus giving a more accurate representation of what the law requires. Apparently the change of the title in 1988 *only* affected what appeared in the Government Printing Office (“GPO”) version of the Code, as it did *not* actually amend the “*Statutes at Large.*” So the title is now different in different printings. Because the USCS is generally more reflective of the underlying law itself, that is the version which this report will defer to.

It should be mentioned that while titles of parts may give an indication of what the part is about, the *title has no effect on the actual legal application.*

“...nor shall any *table of contents, table of cross references, or similar outline, analysis, or descriptive matter relating to the contents of this title be given any legal effect.*”  
[26 USC § 7806(b)]

So when the title was changed in the GPO version (but the *text* of the sections was not), the application of the law did *not* change. What changed was the appearance of the table of contents. Prior to the change, in light of the fact that the income tax applies to “*income from whatever source derived,*” the table of contents made the relevance of 26 USC § 861 obvious:

Subtitle A, “*Income taxes*”  
Chapter 1, “*Normal taxes and surtaxes*”  
Subchapter N, “*Tax based on income from sources within or without the United States*”  
Part I, “*Determination of sources of income*”  
Section 861, “*Income from sources within the United States*”  
861(a) “*Gross income from sources within United States*”  
861(b) “*Taxable income from sources within United States*”

(The *regulations* under 26 USC § 861(b) at the time were entitled “*Computation of taxable income from sources within the United States.*”)

When the title of Part I was changed in the GPO version, and the new title seemed to imply that the part was about “*foreign income,*” it no longer appeared to be an obvious place for most people to look when determining their taxable income. This would certainly have the effect of drawing attention away from Section 861.

Many tax professionals concede that Section 861 and the related regulations show income to be taxable only when it comes from certain activities related to international and foreign commerce. The new title gives the appearance that the part has no relevance to most people, and should not even be examined.

This change resulted in a curious situation: a part whose title says it is about “*foreign income*” is identified as the part which (along with the related regulations) “*determine[s] the sources of income for purposes of the income tax.*”

### 1995

The Paperwork Reduction Act of 1980 requires that every form used by the federal government to collect information from the public first be approved by the Office of Management and Budget (“OMB”). The regulations at 26 CFR § 602.101 contain a table listing the OMB-approved forms for each section of regulations. The regulations at 26 CFR § 1.1-1 are entitled “*Income tax on individuals,*” and correspond to 26 USC § 1 (which imposes the “income tax”).

Up until 1995, the first line in this table identified Form 2555, “*Foreign Earned Income,*” as the only approved form under 26 CFR § 1.1-1. In 1995, after many “tax resistance” groups had become aware of this, the listing for “1.1-1” was removed from the list, in order to avoid “confusion,” according to the Department of the Treasury. The process of applying for, and receiving OMB approval for a form makes the possibility of an error extremely remote. The Department of the Treasury *requested* that Form 2555 be approved for 1.1-1, and the Office of Management and Budget *approved* it. When the entry drew too much attention, it was removed. At present no forms are approved for use with 26 CFR § 1.1-1.

### 15) Clues and Hints

There are numerous other bits of information that hint at the correct application of the law, a few of which are included here as supporting evidence.

#### On the Record

As the Supreme Court and the Secretary of the Treasury have repeatedly stated, the federal income tax is (and has always been) an indirect “excise” tax. Excises, generally speaking, are taxes imposed on certain activities or privileges. In light of this, there are some interesting comments in the Congressional Record from March 27, 1943 (page 2580). A statement is included by a “*Mr. F. Morse Hubbard, formerly of the legislative drafting research fund of Columbia University, and a former legislative draftsman in the Treasury Department*” (clearly someone whose job would require a comprehensive understanding of the proper application of the law). His comments include the following:

*“The income tax is, therefore, not a tax on income as such. It is an excise tax with respect to certain activities and privileges which is measured by reference to the income which they produce. The income is not the subject of the tax: it is the basis for determining the amount of the tax.”*

The income tax is imposed on “*income from whatever source derived*” (minus deductions). The mere receipt of income, by itself, is *not* (and could not be) the subject of this excise tax. It is the “*source*” which is the subject of the tax, and the amount of income received from that

“*source*” is what is used to determine the *amount* of tax due. The above citations coincide well with the fact that the section of regulations for determining taxable income (26 CFR § 1.861-8) states that it applies only to income “*from specific sources and activities.*” And the statutes and regulations under the part which “*determine[s] the sources of income for purposes of the income tax*” all apply only to these same “*specific sources and activities,*” which are all related to international or foreign commerce.

### Section 306

Section 306 of the statutes deals with individuals receiving income from selling certain stocks. After dealing with the income itself, the section discusses the “source” of income.

*“Sec. 306. Dispositions of certain stock*

*(a) General rule*

*If a shareholder sells or otherwise disposes of section 306 stock...*

*(1) Dispositions other than redemptions - If such disposition is not a redemption...*

*(A) The amount realized shall be treated as ordinary income...*

*(f) Source of gain - The amount treated under subsection (a)(1)(A) as ordinary income shall, for purposes of part I of subchapter N (sec. 861 and following, relating to determination of sources of income), be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If under the preceding sentence such amount is determined to be derived from sources within the United States, such amount shall be considered to be fixed or determinable annual or periodical gains, profits, and income within the meaning of section 871(a) or section 881(a), as the case may be.”*

**[26 USC § 306(f)]**

The section states that if the income comes from “sources within the United States,” then it constitutes “gains, profits, and income” under Section 871(a) or 881(a). Sections 871 and 881 deal exclusively with nonresident aliens and foreign corporations respectively (both are found in Part II of Subchapter N, “*Nonresident aliens and foreign corporations*”). The wording of Section 306 implies that if the income in question comes from “sources within the United States,” then it must apply to one of these sections.

If a citizen living and working in the United States receives the type of income dealt with in Section 306, and believes it constitutes “income from sources within the United States,” halfway through the last sentence the reader is left in limbo. The sentence structure is “if A, then B.” Using the usual overly-broad interpretation of the Code, if a *citizen* receives income from the type of stock mentioned from “sources within the United States,” then that income “*shall be considered to be*” taxable for *nonresident aliens* or *foreign corporations*. A contradiction exists, *unless* one realizes that the term “sources of income” has a restricted meaning, which in this case would apply only to foreigners.

### Strange Links

In various sections of the statutes, Section 911 is referenced where it does not seem to fit in, if one accepts the common, overly-broad interpretation of the Code. One example exists in Section 1 itself (the section imposing the income tax on individuals).

Subsection (g) of Section 1 deals with certain income of children being treated as income of that child's parents, and shows that the term "earned income" is defined in 26 USC § 911(d)(2).

*“(g) Certain unearned income of minor children taxed as if parent's income...*

*(4) Net unearned income*

*For purposes of this subsection--*

*(A) In general*

*The term "net unearned income" means the excess of--*

*(i) the portion of the adjusted gross income for the taxable year which is not attributable to earned income (as defined in section 911(d)(2))...* [26 USC § 1(g)]

This section (26 USC § 1(g)) is referred to later in Section 59(j), and Section 911(d)(2) is again mentioned as the section which defines "earned income." Other sections, such as 26 USC § 66(d) and 26 USC § 469(e), also refer to Section 911(d)(2) for the definition of "earned income." There is nothing peculiar about the definition in 26 USC § 911(d)(2) itself, which states the following:

*“(d) Definitions and special rules*

*For purposes of this section--*

*(2) Earned income*

*(A) In general*

*The term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include...* [26 USC § 911(d)]

What is interesting is the **location** of the definition:

*Subchapter N -- Tax based on income from sources within or without the United States*

*Part III -- Income from sources without the United States*

*Subpart B -- Earned income of citizens or residents of United States*

***Sec. 911**. Citizens or residents of the United States **living abroad***

While it is true that the location of such a definition does not legally change the meaning of the definition, it is still somewhat telling that the definition is found in Subchapter N, rather than in Subchapters A and B (which impose the tax, and generally define "gross income" and "taxable income"). It is also telling that the definition itself (though the definition is also "borrowed" by other sections) says that the definition is "*for purposes of this section,*" meaning Section 911, which deals exclusively with the "*foreign earned income*" of United States citizens.

Another strange connection occurs in the section regarding “community income” (which comes shortly after Section 63, which defines “taxable income”).

*“Sec. 66. Treatment of community income*

*(a) Treatment of community income where spouses live apart*

*If- (1) 2 individuals are married to each other...;*

*(2) such individuals-- (A) live apart... (B) do not file a joint return...;*

*(3) one or both of such individuals have earned income for the calendar year which is community income; and*

*(4) no portion of such earned income is transferred (directly or indirectly) between such individuals before the close of the calendar year,*

*then, for purposes of this title, any community income of such individuals for the calendar year shall be treated in accordance with the rules provided by section 879(a).”*

*[26 USC § 66]*

Note that this is giving the rules applicable to all of Title 26 regarding “community income.” But the section it refers to for such rules reads:

*“Sec. 879. Tax treatment of certain community income in the case of nonresident alien individuals*

*(a) General rule - In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:...” [26 USC § 879(a)]*

The text here specifically states that it applies only where one or both are nonresident aliens. To use the same rules for two citizens of the United States, Section 66 would have to say something similar to “shall be treated in accordance with the rules provided by 879(a) regarding nonresident aliens, notwithstanding the fact that the individuals may be citizens or residents of the United States.” But it says no such thing, implying that “community income” applies only if at least one partner is a nonresident alien.

### **Following Instructions**

Form 1040 is divided into several categories, such as personal information, “*Filing Status*,” “*Exemptions*,” “*Income*,” etc. In the instruction booklet for that form, there is a section that gives line-by-line instructions. The general category of “Income” begins as follows:

#### **“Foreign-Source Income**

*You **must report** unearned income, such as interest, dividends, and pensions, from sources **outside the United States** unless exempt by law or a tax treaty. You **must also report** earned income, such as wages and tips, from sources **outside the United States**.*

*If you worked abroad, you may be able to exclude part or all of your earned income.*

*For details, see Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, and Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income*

*Exclusion.*

*Community Property States... \**

*Rounding Off to Whole Dollars...*” [1996 Instruction Booklet for Form 1040]

(\* - This concerns “*community income*,” which is dealt with above. This would apply only to a United States citizen married to a nonresident alien.)

That is all it has to say about the general subject of income. The booklet then tells where the listed “*items*” (interest, dividends, wages, etc.) should be entered on Form 1040. While there is a statement specifically saying that “*you must report*” these items if from *sources outside* the United States, there is *no* statement that these items must be reported if they come from *within* the United States.

This admission in the booklet is very easy for most readers to simply disregard as irrelevant to them. But if there was the need to say that foreign-source income *must* be reported, why was there no need to say that any *other* income must be reported? Why did the statement not say that foreign source income “as well as domestic income” must be reported? One is left free to make the *incorrect assumption* that all income must be reported, when this is not the case.

A similar situation exists with IRS Publication 525, “*Taxable and Nontaxable Income.*” The first thing this publication says concerning taxes, which appears on the *cover*, is:

*“Important Reminder*

*Foreign Source Income*

*If you are a U.S. citizen, you must report income from sources outside the United States (foreign income) on your tax return unless it is exempt by U.S. law.”*

Then, in the introduction (which follows the above “reminder”), the publication states that the publication “*discusses many kinds of income and explains whether they are taxable or nontaxable.*” Other than the “foreign source income” reminder, the publication deals only with “*items*” of income, not “*sources.*” Again, one is left free to *assume* that income from within the United States is taxable to U.S. citizens, *but it is not stated.*

The two documents cited above, which say that citizens “must report” income coming from *outside* of the United States, coincide perfectly with the older regulations defining “gross income.” For example, the 1922 income tax regulations state that certain income not exempted by statute is nonetheless free from taxation because of “fundamental law” (the Constitution). The regulations then state that “[s]uch tax-free income should not be included in the return of income and need not be mentioned in the return.”

At the same time, the regulations also stated that “[p]rofits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income” (and then mention special rules regarding foreigners and those who have possessions income). The current IRS publications, as shown above, still contain similar language.

### Treasury Decision 2313

The Supreme Court's decision in the Brushaber case in 1916 (240 U.S. 1) is often cited by the IRS as demonstrating that the income tax is Constitutional (which it is, *because* of its very limited legal application). What the IRS fails to mention, and what is not apparent from looking at the court's ruling in the case, is that the case concerned income from within the United States accruing to a nonresident alien, which *is* subject to the income tax. Treasury Decision 2313 makes this apparent.

*“Under the decision of the Supreme Court of the United States in the case of Brushaber v. Union Pacific Railway Co., decided January 24, 1916, it is hereby held that income accruing to nonresident aliens in the form of interest from the bonds and dividends on the stock of domestic corporations is subject to the income tax imposed by the act of October 3, 1913.”* [Treasury Decision 2313]

Note how in this case an “item” of income (interest) is subject to the income tax when paid to *nonresident aliens*, because nonresident aliens getting domestic income is one of the legal “sources” of taxable income. The decision also states a proper use of Form 1040.

*“The responsible heads, agents, or representatives of nonresident aliens, who are in charge of the property owned or business carried on within the United States, shall make a full and complete return of the income therefrom on Form 1040, revised, and shall pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals.”* [Treasury Decision 2313]

While this in itself does not prove that Form 1040 should not be used in any other situation, something telling appears later in the decision. Speaking of the responsibility of fiduciaries of domestic entities, it states:

*“[W]hen there are two or more beneficiaries, one or all of whom are nonresident aliens, the fiduciary shall render a return on Form 1041, revised, and a personal return on Form 1040, revised, for each nonresident alien beneficiary.”*

This both implies that a Form 1041 is not required if there are no nonresident alien beneficiaries (only citizens and residents), as well as implying that a Form 1040 is not to be issued for the citizen and resident beneficiaries.

### Other Clues

As mentioned above, the only form ever approved for use with section 26 CFR § 1.1-1 of the regulations (under the Paperwork Reduction Act) was Form 2555, “*Foreign Earned Income*.”

In addition, the only form approved by the Office of Management and Budget for 26 CFR § 1.861-2 and -3 (which deal with interest and dividends from within the United States) is Form 1040NR, “*U.S. Nonresident Alien Income Tax Return*.” Similarly, the only form approved under 26 CFR § 1.861-8 itself is Form 1120-F, “*U.S. Income Tax Return of a Foreign Corporation*.”

Below each section of regulations in the CFR there is a citation of the legal authority under which the regulations are made. The statutory authority for 26 CFR § 1.861-8 is listed as 26 USC § 7805 (which is the general rule-making authority for the Secretary, as shown in the first citation of this report), as well as 26 USC § 882(c), which reads:

*“Tax on income of foreign corporations connected with United States business...*

*(c) Allowance of deductions and credits*

*(1) Allocation of deductions*

*(A) General rule... the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary.” [26 USC § 882(c)]*

This matches the fact that only the income tax return for a foreign corporation has been approved for use with this section of regulations by the OMB. The newer, temporary regulations in 26 CFR § 1.861-8T cite no *statutory* authority, but instead cite Treasury Decision 8228, which states that the authors of the regulation both work in the “*Office of the Associated Chief Counsel (International)*.” The scope of the regulations is identified in the first paragraph of Treasury Decision 8228:

*“Summary: This document provides temporary Income Tax Regulations relating to the allocation and apportionment of interest expense and certain other expenses for purposes of the foreign tax credit rules and certain other international tax provisions.”*

*[Treasury Decision 8228]*

So the authorities cited as the legal basis for the regulations for “*determining taxable income from sources within the United States*” (temporary and final) show that the regulations are about international commerce.

Another legal resource which demonstrates the true applicability of the “income tax” is the annotated index of the United States Code. While there are different versions which vary somewhat in exact wording, under “*Income tax, citizens*,” only things such as citizens “*living abroad*” or “*about to depart from U.S.*” are listed.

Both the indexes and the contents of “Internal Revenue Bulletins” (which contain rulings and decisions by the IRS regarding interpretation of the law) reinforce the conclusions of this report. For example, the 1957-1960 cumulative bulletins have nine listings under “Citizens,” every one of which deals with citizens being *outside* of the United States. This same bulletin, under “*Income - Source*,” has 35 listings, all of which deal with specific issues related to *international* commerce, with one exception; and that exception again reinforces the significance of Part I of Subchapter N, and the related regulations:

*“Within and without United States; determination. - Rules are prescribed for determination of gross income and taxable income derived from sources within and without the United States... §§ 1.861-1 through 1.864. (Secs. 861-864; '54 Code) T.D. 6258, C. B. 1957-2, 368.”*

The bulletins show similar patterns year after year, from 1913 (when the basis of the current federal income tax was written) to the present.

Another resource which indicates the true nature of the “income tax” is the Internal Revenue Manual, which is the instruction manual for all divisions of the Internal Revenue Service. The Criminal Investigation Division of the IRS is the division which deals with criminal violations of the federal “income tax” laws, including tax evasion and failure to file a return. Section 1132.55 of the Internal Revenue Manual (entitled “*Criminal Investigation Division*”) begins as follows:

*“The Criminal Investigation Division enforces the criminal statutes applicable to income, estate, gift, employment, and excise tax laws... involving United States citizens residing in foreign countries and nonresident aliens subject to Federal income tax filing requirements...”* [IRM, Section 1132.55 (1991 Ed.)]

Similarly, the federal regulations found in 26 CFR § 601.101(a) describe in general the functions of the Internal Revenue Service. The only specific mention in these regulations of who or what is subject to taxes administered by the Internal Revenue Service reads as follows:

*“The Director, Foreign Operations District, administers the internal revenue laws applicable to taxpayers residing or doing business abroad, foreign taxpayers deriving income from sources within the United States, and taxpayers who are required to withhold tax on certain payments to nonresident aliens and foreign corporations...”*  
[26 CFR § 601.101(a)]

In keeping with the deceptive structure used throughout the statutes and regulations, the reader is left to *assume* that some other matters are also under IRS jurisdiction, but nothing else is specifically mentioned.

## **16) The Other Side**

As most tax professionals believe that most Americans have taxable income, their position regarding Section 861 and other matters should be specifically presented and refuted. The incorrect readings of Section 861 and related regulations fall into two main categories. The two approaches are in conflict with each other, and both are provably incorrect.

### **Pay No Attention**

The first erroneous general “interpretation” which tax professionals have regarding Section 861 is that it is usually irrelevant, and should be ignored by most people.

This approach rests on the misreading of “*from whatever source derived*” (as used in 26 USC § 61) to mean “no matter where it comes from.” In all three major printings of Title 26 (USC, USCS, USCA), Section 61 itself has a cross-reference similar to the following:

*“Income from sources -  
 Within the United States, see section 861 of this title  
 Without the United States, see section 862 of this title”*

The Indexes of the United States Code reinforce the point, with entries such as:

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

(While neither the cross-reference nor the index are technically the law, they certainly indicate that one should reference 26 USC § 861 for the details about gross income from “sources” within the United States.)

On examining Section 861 itself, we find that it is entitled “*Income from sources within the United States.*” The first subsection (26 USC 861(a)) is entitled “*Gross income from sources within United States,*” and it identifies what “*shall be treated as income from sources within the United States.*” There is no indication in the section that it should only be used if someone also has income from *outside* the states, and there is no indication that it only determines in certain unusual cases what “*shall be treated as income from sources within the United States.*” (While it is easy for a reader to *assume* that he knows what “income from sources within the United States” means, the law specifically answers the question, so speculations and assumptions are irrelevant.)

The second subsection (namely, 26 USC § 861(b)) is entitled “*Taxable income from sources within United States,*” and it states how to determine what “*shall be included in full as taxable income from sources within the United States.*” Again, the text gives no indication whatsoever that these sections should only be used to determine “*gross income*” and “*taxable income*” from within the United States in certain unusual circumstances.

But the language of the statutes is not all that the “experts” have to ignore in order to come to their erroneous conclusion. The regulations also explicitly and repeatedly show the relevance of 26 USC § 861. These regulations fall under the heading of “Determination of sources of income” in the Code of Federal Regulations.

*“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... The statute provides for the following three categories of income:*

*(1) Within the United States. The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See Secs. 1.861-2 to 1.861-7, inclusive, and Sec. 1.863-1. The taxable*

*income from sources within the United States, in the case of such income, **shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a)**, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See Secs. 1.861-8 and 1.863-1.*

(2) *Without the United States...*

(3) *Partly within and partly without the United States...*

*(b) Taxable income from sources within the United States. The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.* [26 CFR § 1.861-1]

While it is true that some people have to “apportion” certain income which comes partly from inside and partly from outside the states (under 26 USC § 863), there is no indication at all that 26 USC § 861 is to be used to determine taxable income from within the states *only* in these unusual circumstances.

In fact, such an “interpretation” (or more accurately, “baseless assertion”) is specifically shown to be incorrect in another section of the regulations:

*“(ii) Relationship of sections 861, 862, 863(a), and 863(b)... **Each of these four provisions applies independently**... [T]wo or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction.”* [26 CFR § 1.861-8(f)(3)(ii)]

If the situation involves income *only* from “sources” *within* the United States, 26 USC § 861 and its *regulations* apply. If the situation involves only income from “sources” *outside* the United States, 26 USC § 862 and its regulations apply. If the question is about income that comes partly from within and partly from without the United States, 26 USC § 863, and possibly 861 and/or 862 as well, and related regulations apply. The claim that 26 USC § 861 only applies in the last scenario is simply without merit.

(The tax professionals are aware that 26 USC § 861 *would* apply to a nonresident alien getting income from *within* the United States, even if he received no income from *outside* of the states, thus destroying any claim that only those who have both “within” *and* “without” income should be looking at the section.)

Some tax professionals claim that most people should ignore Section 861 based upon the title of Part I of Subchapter N (the first section of which is 26 USC § 861). In 1988, the title was changed from “*Determination of sources of income*” to “*Source rules and other general rules relating to foreign income*” in the Government Printing Office version of the Code.

(See page 88 regarding the change in the title of Part I.) The claim is that “if you don’t have foreign income, you shouldn’t be looking there.”

While the precise meaning of the new title is debatable, there is a more basic reason to dismiss such an argument. 26 USC § 7806(b) states that titles have *no* legal effect; only the actual text

is the law. When the title of Part I changed in 1988, the text of the law did *not* change. (In addition, anyone relying on the title alone would have to argue that before 1988, when the title was changed, the tax only applied to those engaged in international or foreign commerce.)

The actual text of the sections, as well as the related regulations, shows no indication that most people should ignore this part. Regardless of the title, there is even *more* evidence (in addition to what is above) that **26 USC § 861(b)**, and the corresponding regulations found in **26 CFR § 1.861-8**, are the specific sections to be used for determining taxable income from sources within the United States.

*“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.” [26 CFR § 1.861-8]*

*“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.”*  
[26 CFR § 1.863-1(c)]

In the above citation, the regulations prove the point *twice* in one sentence. First it says that taxable income from within *or* without is to be *determined* under the cited sections, which means that one does not need income from within *and* without for the section to apply. Then in the second half of the sentence, it specifically refers to the cited sections (26 CFR § 1.861-8 and following) as the sections “for determining taxable income from sources within the United States.” Additional citations agree.

*“Sec. 1.861-8 [is the section] for determining the taxable income from sources within the United States.” [26 CFR § 1.862-1]*

If not for the previous citations, some might try to bicker over the correct legal application, based on the use of the word “and” in the following two citations. But in light of the above, they just add *more* support to the relevance of 26 USC § 861.

*“Secs. 1.861-1 to 1.863-5, [give the principles] for determining the gross and the taxable income from sources within and without the United States.” [26 CFR § 1.863-6]*

*“Rules are prescribed for determination of gross income and taxable income derived from sources within and without the United States... §§ 1.861-1 through 1.864. (Secs. 861-864; '54 Code.)” [Treasury Decision 6258]*

Again, there is *no basis* for any assertion that **26 USC § 861(b)** and **26 CFR § 1.861-8** should *not* usually be used to determine taxable income from sources within the United States. And there is no support for the claim that most people should *not* examine 26 USC § 861 to determine what constitutes “income from sources within the United States.”

(Some reading the general wording of 26 USC § 861 may get an incorrect, overly-broad impression of which domestic income is taxable, and that issue is dealt with below.)

This general “pay no attention” position is the result of backwards logic. The tax professionals start with the *incorrect assumption* that most people receive taxable income. Therefore, when they discover that 26 USC § 861 and the related regulations do *not* show most income to be taxable, they incorrectly conclude (based on a false premise) that that section should not be used by most people, even though the statutes and regulations clearly state otherwise. This error is usually stated as “that section doesn’t *apply* to you.” The following analogy demonstrates the logical flaw with this half-truth.

As shown above (see page 88), one section of the statutes of Subtitle E states that the Secretary shall maintain a central registry of “*all firearms.*” But a separate section defines the term “*firearm,*” and the legal meaning is far more restrictive than the meaning of the word in common English. For example, a basic hunting rifle is obviously a “firearm” in common English, but is *not* considered a “firearm” for purposes of Section 5841. An individual who owns a hunting rifle could, therefore, correctly state that Section 5841 does not impose any obligation on him.

Now imagine someone arguing to him the following: “The definition of ‘firearms’ *doesn’t apply* to your firearm, so you should just ignore the definition in Section 5845. Just look at Section 5841, where it says ‘all firearms.’ That includes your rifle.” Such an argument would be ludicrous, and yet this is precisely the logic (or lack of logic) used by the tax professionals regarding 26 USC § 861. Section 61 defines “*gross income*” generally as “*all income from whatever source derived,*” and Part I of Subchapter N (Section 861 and following) and related regulations “*determine the sources of income for purposes of the income tax.*”

Many tax professionals will argue that Section 861 “*doesn’t apply*” to most people, and therefore most readers should *ignore* the sections which “*determine the sources of income for purposes of the income tax.*” This is entirely illogical, but it is the only way for the tax professionals to avoid admitting their monumental error. Contrary to the evidence, they continue to claim that most citizens receive taxable income.

The following shows yet another link between Section 61 and Section 861, by specifically stating that the “items” of income listed in *Section 61* can include income which is *not taxable*.

A “class of gross income” “*may consist of one or more items... of gross income enumerated in section 61.*” [26 CFR § 1.861-8(a)(3)]

“[P]aragraph (d)(2) of this section... provides that a class of gross income may include excluded income.” [26 CFR § 1.861-8(b)(1)]

(26 CFR § 1.861-8(d)(2) just redirects the reader to 26 CFR § 1.861-8T(d)(2).)

“*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.*” [26 CFR § 1.861-8T(d)(2)(ii)]

“(iii) *Income that is not considered tax exempt. The following items are not considered to be exempt, eliminated, or excluded income...*

(A) *In the case of a foreign taxpayer...*

(B) *In computing the combined taxable income of a DISC or FSC...*

(C) *...the gross income of a possessions corporation...*

(D) *Foreign earned income...*” [26 CFR § 1.861-8T(d)(2)(iii)]

The link between 26 USC § 61 and 26 USC § 861 (regarding income from “sources” *within* the United States) is solidified by examining the regulations under the predecessor to 26 USC § 61, namely, Section 22(a) of the Internal Revenue Code of 1939. In defining “gross income,” the older regulations state that it means all income, except income which is exempted by statute, or income which is “*under the Constitution, not taxable by the Federal Government.*” Then the regulations gave a list of non-exempt income which is very similar to the above citation (from the current regulations).

*“Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations... and, in certain cases... for citizens and domestic corporations deriving income from sources within possessions of the United States.”* [26 CFR § 39.22(a)-1 (1945)]

Notice, this is under the predecessor of Section **61**, not Section **861**. But not surprisingly, the regulations under the predecessor of 26 USC § 861 (Section 119 of the 1939 Code) listed the exact same activities relating to income from *within* the United States: “Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251” (only those who receive most of their income from within federal possessions were “*entitled to the benefits of section 251*”). So denying the current relevance of Section 861 requires one to also ignore the legislative and regulatory history.

Except for the general definition of “gross income” (“*income from whatever source derived*”), the main citation used by tax professionals to justify their misinterpretation of the law is found in the regulations related to Section 1 of the statutes, which imposes the tax.

*“Sec. 1.1-1 Income tax on individuals.*

(a) *General rule. (1) Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States... The tax imposed is upon taxable income (determined by subtracting the allowable deductions from gross income)...*

(b) *Citizens or residents of the United States liable to tax. In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.”* [26 CFR § 1.1-1]

This section by itself certainly gives the appearance that the tax applies to most United States citizens. However, when one understands what the terms used in this section legally mean, the conclusion is quite different.

First, the tax does not apply to the income of every citizen, only to the “taxable income” of every citizen. Every tax professional knows that it is very possible to have income (in some cases millions of dollars of income) without having any taxable income. And the section itself admits that the tax applies only to “taxable income,” which is generally “gross income” minus deductions.

But the more significant statement is found in 26 CFR § 1.1-1(b), which states that citizens are taxed on their income, whether “from sources within or without the United States.” This is absolutely *true*, but easy to misconstrue. Because “*Section 861 and following... and the regulations thereunder, determine the sources of income for purposes of the income tax*” (26 CFR § 1.861-1), the meaning of income “from sources within or without” the U.S. is already dependent upon 26 USC § 861 and following. But there are several more specific points regarding the legal meaning of “from sources within or without the United States.”

If a citizen is taxed on his income, whether “*from sources within or without the United States,*” it would certainly be logical to examine that portion of the law which elaborates on “*Tax based on income from sources within or without the United States.*” That is the title of Subchapter N of the Code. Section 1.1-1 was written prior to 1986, and back then Subchapter N *did* describe situations in which citizens could have taxable income from “within” or “without” the United States, or both.

However, conspicuously absent from Subchapter N is any mention of the income of most Americans. Sections 901 and 911 (and others) deal with income that citizens receive from sources *outside* of the United States. Up until 1986, citizens were also taxable on income received *within* the United States, if they first receive a large portion of their income from within federal possessions.

*“In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States-- (i) If 80 percent or more of the gross income... was derived from sources within a possession of the United States, and (ii) If 50 percent or more of the gross income... was derived from the active conduct of a trade or business within a possession of the United States...*

*(c) Amounts received in the United States. Notwithstanding the provisions of section 931(a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States.”*

[26 CFR § 1.931-1]

Regarding citizens having taxable income, these are the *only* situations described in the portion of the law concerning “*Tax based on income from sources within or without the United States*”

(Subchapter N). To assume that matters not mentioned in this part of the law still constitute “*income from sources within or without the United States*” is contrary to established legal principles.

*“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.”*

[Gould v. Gould, 245 U.S. 151 (1917)]

But, as if that weren't enough, there is something that even more conclusively rebuts the misreading of 26 CFR § 1.1-1. To review, that section states the following:

*“The tax imposed is upon taxable income... In general, all citizens of the United States... are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.”* [26 CFR § 1.1-1]

In light of the following, it becomes absurd to deny the relevance of 26 USC § 861 and the related regulations:

*“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.”* [26 CFR § 1.863-1(c)]

In addition, the Index of the Code of Federal regulations has an entry which reads “*Income from sources inside or outside U.S., determination of sources of income, 26 CFR 1 (1.861-1--1.864-8T).”*

The regulations in 26 CFR § 1.1-1 are a masterpiece of deception. While being literally correct (as the law must be), they seem designed to give a false impression. For example, the language could have just as easily (and just as correctly) stated that “everyone on earth, no matter where he is and no matter where his income comes from, is taxable upon his taxable income.”

The meaning of the statement is, of course, totally dependent upon the meaning of “taxable income.” It is a word game, where what may be inferred differs from what is actually stated. If someone does not have “taxable income,” then **26 CFR § 1.1-1** becomes irrelevant. Nothing in the section has any effect on the legal meaning of “taxable income” or “sources of income.” Instead, the section uses these terms in a context which makes them sound less restricted.

(As a reminder, the only form ever approved for use with Section 1.1-1 under the Paperwork Reduction Act was Form 2555, “*Foreign Earned Income.*”)

The predecessors of the current regulations were worded slightly differently.

*“19.11-1 Income tax on individuals*

*Chapter 1 of the Internal Revenue Code [\*]... imposes an income tax on individuals, including a normal tax (section 11), a surtax (section 12), and a defense tax [\*]...*

*The tax is upon net income which is determined by subtracting the allowable deductions from the gross income. (See generally 21 to 24, inclusive.)”*

[\* - Words omitted related only to which years the law was applicable.]

*“19.11-2 Citizens or residents of the United States liable to tax*

*In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States.”*

The wording of these regulations (from 1945), while deceptive, does not give quite as persuasive a deception as the current regulations. The only solid conclusion which can be inferred from these older regulations is that income from *outside* of the United States can be taxable to United States citizens and residents.

### Out of Context

The second erroneous “interpretation” which tax professionals have regarding Section 861 is that everyone should use it, but that it *does* show the income of most people to be taxable. This is an easy mistake to make, based on reading Section 861 of the statutes out of context, and without knowing the history of the section. (There is plenty of evidence suggesting that the statutes and regulations have been altered specifically to allow for such a misreading, while the previous statutes and regulations stated the truth more clearly.)

*“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... [certain exceptions]*

*(3) Personal services - Compensation for labor or personal services performed in the United States; except... [certain exceptions]*

*(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 [allowable deductions]. The remainder, if any, shall be included in full as taxable income from sources within the United States.” [26 USC § 861]*

It is easy to see how this could be read to mean that the income of all citizens who live and work within the states “*shall be treated as income from sources within the United States,*” and after taking deductions, “*shall be included in full as taxable income from sources within the United States.*” (However, even most tax professionals know that such a reading of this section is incorrect.)

To fully understand the application of **26 USC § 861**, it is *essential* to understand the *structure* of Subchapter N of the Code, which is entitled “*Tax based on income from sources within or without the United States.*” As the title implies, Subchapter N elaborates on which income from “sources” inside or outside the United States is taxable. Subchapter N is divided into five “Parts,” which are titled as follows:

- Part I - “*Determination of sources of income*” \*
- Part II - “*Nonresident aliens and foreign corporations*”
- Part III - “*Income from sources without the United States*”
- Part IV - “*Domestic international sales corporations*”
- Part V - “*International boycott determinations*”

(\* See page 88 concerning the title of Part I of Subchapter N.)

Parts II through V describe certain activities which are taxable. For example, Part II includes 26 USC § 871 and 26 USC § 882, which state that nonresident aliens and foreign corporations “shall be taxable” on the income they receive from doing business within the 50 states; and Part II includes 26 USC § 911, which shows that U.S. citizens are taxable on their “foreign earned income” (after a large exemption). Prior to 1986, 26 USC § 931 showed that citizens were also taxable on income received *within* the United States if they also receive a large amount of income from within federal *possessions*.

Part I includes 26 USC §§ 861 - 865, which give the general “source rules” for determining what income counts as coming from “within” and what counts as coming from “without” the United States. However, these sections are only about the income of those engaged in the taxable activities described in the *other* “Parts” of Subchapter N.

For example, under 26 USC § 871 nonresident aliens are not taxed on income they receive which is unrelated to the United States (i.e. their foreign-source income). Nonresident aliens, therefore, must distinguish between “within” income and “without” income, to determine their taxable income (and they do that using 26 USC § 861 and following). In addition, a United States citizen who receives a large amount of income from within federal *possessions* is also only taxed on the income he receives from *within* the United States. These are the *only* individuals whose income is made taxable by the general terminology used in 26 USC § 861, and these are the *only* individuals who can have “*taxable income from sources within the United States.*”

The current regulations show that this is the case. This shows that the “general terms” used in Section 861 of the statutes only applies to income from “specific sources.”

*“Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States...” [26 CFR § 1.861-8]*

*“(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.” [26 CFR § 1.861-8(f)(3)(ii)]*

As shown above, 26 USC 861(b) says that the “items” of gross income listed in 861(a), after subtracting deductions, “shall be included in full as taxable income from sources within the United States.” However, the corresponding regulations are found in 26 CFR § 1.861-8, and state in the first paragraph that they “apply in determining taxable income of the taxpayer from specific sources and activities.” So again we see that the general terms of 861 of the statutes apply only to income from “specific sources.” And the regulations in three places tell us what is meant by “specific sources.”

*“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.” [26 CFR § 1.861-8(a)(1)]*

*“[T]he term ‘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.)” [26 CFR § 1.861-8(a)(4)]*

*“The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which gives rise to statutory groupings [see previous citation] to which this section is applicable include the sections described below.*

*(i) Overall limitation to the foreign tax credit...*

*(ii) [Reserved]*

*(iii) DISC and FSC taxable income... [international, foreign sales corporations]*

*(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)...*

*(v) 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...*

*(B) The amount of foreign mineral income...*

*(C) [Reserved]*

*(D) The amount of foreign oil and gas extraction income...*

*(E) The tax base for citizens entitled to the benefits of section 931 and the section 936 tax credit of a domestic corporation...;*

*(F) (deals with Puerto Rico tax credits)*

*(G) (deals with Virgin Islands tax credits)*

*(H) The income derived from Guam by an individual...*

*(I) (deals with China Trade Act corporations)*

*(J) (deals with foreign corporations)*

*(K) (deals with insurance income of foreign corporations)*

*(L) (deals with countries subject to international boycott)*

*(M) (deals with the Merchant Marine Act of 1936)” [26 CFR § 1.861-8(f)(1)]*

This is the list of “specific sources” to which the general wording of 26 USC § 861 and following apply. While various foreign tax credits and obscure possessions rules complicate matters, those taxable on their income from within the United States are still nonresident aliens and foreign corporations who receive income from within the United States (item “(iv)” on the list), and citizens and domestic corporations which receive possessions income (item “(vi)(E)” and following).

The current regulations under 26 CFR § 1.861-8 are more than *thirty* pages long, and have been that way since 1978. Prior to 1978, the section was less than one page long, and there was no mention of “operative sections,” “statutory groupings,” “specific sources,” etc.

This explosion in the size and complexity of these regulations happened without a significant change in the wording of the statutes (which have remained basically the same for more than 70 years).

While the truth can still be found about the proper application of 26 USC § 861 (as shown above), it has certainly become more complicated than it was previously.

Sections 861 through 864 of the current statutes came from Section 119 of the 1939 statutes, which used very similar wording as the current sections.

*“Sec. 119. Income from sources within United States*

*(a) Gross income from sources in United States. The following items of gross income shall be treated as income from sources within the United States:*

*(1) Interest...*

*(3) Personal services - Compensation for labor or personal services performed in the United States...”*

However, the regulations under the 1939 Code quite showed quite plainly the limited application of the general terms of this section of the statutes.

*“Sec. 29.119-1. Income from sources within the United States.*

*Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States...*

*The Internal Revenue Code divides the income of such taxpayers into three classes:*

*(1) Income which is derived in full from sources within the United States;*

*(2) Income which is derived in full from sources without the United States;*

*(3) Income which is derived partly from sources within and partly from sources without the United States.*”

Section 251 of the 1939 Code became 26 USC § 931 of the 1954 Code. Only those who received a large amount of income from federal *possessions* were “*entitled to the benefits of section 251*” (the “benefit” being that only their income from within the states was taxable). The general wording of the statutes only applied to the income of “*such taxpayers,*” meaning those engaged in the taxable activities described in *other* sections of the Code (now called “operative sections” in the current regulations).

To give a more specific example, the 1939 statutes said this:

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

*(1) Interest. - Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including...”*

[26 USC § 119 (1939)]

While the related regulations said this:

*“There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations, and citizens of the United States, or domestic corporations which are entitled to the benefits of section 251, all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except...”* [26 CFR § 29.119-2 (1945)]

While the older regulations clearly show the limited application of the predecessors of 26 USC § 861, going even further back shows the *statutes* proving this as well. The following is the 1921 predecessor of the current Sections 861 through 864.

*“Sec. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:*

*(1) Interest...*

*(3) Compensation for labor or personal services performed in the United States...”*

[Section 217, Revenue Act of 1921]

While this section mentioned only *individuals*, Section 232 of the same Act stated that “[i]n the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.”

Other than the tell-tale phrase “vanishing,” the text is very similar to the current Section 861. There can be no doubt about the correct application of the 1921 statute, and the regulations (past and present) show that the scope of the section has not changed.

(If someone insists, based on reading Section 861 by itself and out of context, that all income from within the United States is taxable to everyone, then he would also have to claim that Section 862, by itself and out of context, shows that all income from *outside* the United States is taxable to everyone, as the wording is very similar. It states, in the same general terms, that “*compensation for labor or personal services performed without the United States*” “*shall be treated as income from sources without the United States,*” and that after taking allowable deductions, the remainder “*shall be treated in full as taxable income from sources without the United States.*”

Either several hundred million Chinese owe the United States a lot of money, or the general language in Sections 861 and 862 *only* applies to those engaged in activities described *elsewhere* in Subchapter N, such as a United States citizen living and working in a foreign country (see 26 USC § 911).)

### **Residual Groupings**

(The following explanation deals with an issue which was most likely *intended* to be confusing. It is included for the purpose of being thorough in documenting and refuting anything likely to be used to try to counter the conclusions of this report.)

Some who are unaware of the statutory and regulatory history of 26 USC § 861 may claim, based on the current regulations, that all income that comes from somewhere other than the “specific sources” makes up a “residual grouping” of gross income, which is nonetheless taxable. This position is based entirely on the current regulations in 26 CFR § 1.861-8, which state the following:

*“[T]he 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.’ ” [26 CFR § 1.861-8(a)(4)]*

So “statutory groupings” means income from the specific taxable “sources” listed in 26 CFR § 1.861-8(f)(1). The implication some see here is that income from *other* “sources” (referred to as “*residual groupings*”) can also be taxable, because it too is referred to as “gross income.” The idea is that “gross income” must constitute “taxable income” (after deductions are subtracted), since the definition of “taxable income” is “gross income” minus deductions. However, the regulations often use the term “gross income” in a more generic way, meaning any income, whether taxable or not. In fact, the regulations specifically state that the “*residual grouping*” may be excluded from federal taxation.

*“[T]he 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.” [26 CFR § 1.861-8(a)(4)]*

And the regulations lead to this list of what is not exempt from taxation:

- “(A) In the case of a foreign taxpayer...*
- (B) In computing the combined taxable income of a DISC or FSC...*
- (C) ...the gross income of a possessions corporation...*
- (D) Foreign earned income...” [26 CFR § 1.861-8T(d)(2)(iii)]*

A clear example of tax-exempt income being referred to as “gross income” in a “residual grouping” is shown below. As stated in 26 USC § 882(a)(2), foreign corporations are only taxable on “*gross income which is effectively connected with the conduct of a trade or business within the United States.*” The following example therefore shows that any regulation which discusses “gross income” (not “taxable income”) from the “residual grouping” in no way shows that the residual grouping must be taxable.

*“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.” [26 CFR § 1.861-8(g), Example 21]*

The fact that the regulations refer to income as “gross income” clearly does *not* mean it is taxable. In discussing compensation for services performed in the U.S., the regulations state the following:

*“Gross income from sources within the United States includes compensation for labor or personal services performed in the United States...” [26 CFR § 1.861-4]*

In the generic sense, compensation for labor within the United States is always “gross income.” However, as the current regulations *repeatedly explain*, it can only be “taxable income” *if* it comes from a “specific source.” The predecessor regulations dealt with this “item” of income in a very similar way, but the context of the surrounding regulations made it perfectly clear in what situations this “item” could be taxable.

*“Sec. 29.119-1. Income from sources within the United States.  
Nonresident alien individuals, foreign corporations, and citizens of the United States or domestic corporations entitled to the benefits of section 251 are taxable only upon income from sources within the United States...”*

*The Internal Revenue Code divides the income of such taxpayer into three classes:*

- (1) Income which is derived in full from sources within the United States;*
- (2) Income which is derived in full from sources without the United States;*
- (3) Income which is derived partly from sources within and partly from sources without the United States...*

*Sec. 29.119-2. Interest...*

*Sec. 29.119-3. Dividends...*

*Sec. 29.119-4. Compensation for labor or personal services. - Except as provided in*

*section 119(a)(3), gross income from sources within the United States includes compensation for labor or personal services performed within the United States...*

*Sec. 29.119-5. Rentals and royalties...*

*Sec. 29.119-6. Sale of real property...*

*Sec. 29.119-10. Apportionment of deductions.*

*From the items specified in sections 29.119-1 to 29.119-6, inclusive, as being derived specifically from sources within the United States there shall, in the case of nonresident alien individuals and foreign corporations engaged in trade or business within the United States, be deducted [allowable deductions]. The remainder shall be included in full as net income from sources within the United States..."*

The fact that income is referred to in the regulations as "gross income" does **not** mean it is taxable for everyone. Deductions must be divided between the "statutory grouping" (income from a "specific source") and the "residual grouping" (income from anywhere else). This does **not** mean that the "residual grouping" is taxable. The regulations show in several places that there **must** be an "operative section" which applies in order to determine taxable income.

*"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." [26 CFR § 1.861-8(a)(2)]*

The regulation which states that the "residual grouping" may be exempt from taxation also shows that there must be an "operative section" applicable.

*"In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income."*  
[26 CFR § 1.861-8(a)(4)]

This is only logical, based on the simple fact that the section "*for determining taxable income from sources within the United States*" (26 CFR § 1.861-8) states over and over again that it is for determining taxable income from "*specific sources*," not the "residual groupings."

*"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..." [26 CFR 1.861-8(a)(1)]*

*"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..."*  
[26 CFR 1.861-8(f)(1)]

*"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..." [26 CFR § 1.861-8(a)(2)]*

The regulations (and statutes) are not about determining taxable income from anywhere other than the “specific sources.” Part of the confusion is from the fact that, in stating that the “residual grouping” *may* consist of excluded income, the regulations imply that it also *may* be taxable. This is *correct*, but deceptive. The possibility of the “residual grouping” being taxable could easily lead to the erroneous conclusion that income from somewhere *other* than the “specific sources” might be taxable. The assumption is that the “residual grouping” *cannot* be from one of the listed “specific sources,” but that is not the case.

In doing the calculations for two “specific sources” (described in “operative sections”), the regulations state that all the calculations must be done for each “specific source” *separately*. Paragraph (f)(1) lists the “specific sources” under the “operative sections,” and then the next paragraph states the following:

*“Where more than one operative section applies, it may be necessary for the taxpayer to apply this section separately for each applicable operative section.”*

[26 CFR § 1.861-8(f)(2)(i)]

While a person is calculating all the deductions, etc. for the first “specific source,” his income from the second “specific source” falls in the category of “*residual grouping*.” Likewise, when he is doing the calculations for the taxable income from the second “specific source,” the income from the first is in the “*residual grouping*.” The temporary regulations at 26 CFR § 1.861-8T demonstrate this.

*“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.”* [26 CFR § 1.861-8T(c)(1)]

(The same thing is said again in 26 CFR § 1.861-8T(f)(1)(ii).)

So even an example in the regulations showing that the “residual grouping” may be taxable does *not* prove that income from somewhere other than the “specific sources” may be taxable. (And the “operative sections” involving individuals receiving income from within federal possessions also makes it possible for a taxpayer to have “taxable income” from within *and* without the United States, adding further room for confusion.)

The “residual grouping” argument relies on making assumptions based on something that complex deduction allocation examples might seem to suggest, but *do not state* (that income *not* from the “specific sources” can be taxable), while at the same time ignoring several sections of regulations which contradict this theory. The over-complexity of these regulations seems designed to cause confusion and uncertainty. But even if the current complicated regulations by themselves, combined with some “creative interpretation,” allowed for the “residual grouping” argument to have some credibility, the *older regulations* (as shown above) *erase* that credibility entirely.

The 1945 regulations made no mention of “operative sections,” “specific sources,” “statutory groupings” or “residual groupings,” and did not consist of dozens of pages of a jumbled, confusing mess. Since there was nothing about “residual groupings” back then to base an argument on, to use the argument now would require the claim that since 1945 there must have been a massive expansion of what income is taxable, from international and foreign commerce to all commerce. One would also have to claim that the Secretary decided to inform the public of this by subtle innuendos hidden in confusing examples about deduction allocation rules related to the per-country limitation on the foreign tax credit.

(Meanwhile, Congress stated that “no substantive change” was made in the law.) Obviously, such a claim would be absurd.

The ridiculous complexity of the current regulations under 26 USC § 861, and particularly the explosion in 1978 of the regulations in 26 CFR § 1.861-8 from less than *one* page to more than *thirty* (with no corresponding change in the statutes) certainly seems to show an intent to obfuscate the truth. If the goal was to convey the truth, 26 CFR § 1.861 would look something like this:

*“The items of income listed in 26 USC § 861 are taxable only to nonresident aliens, foreign corporations, and prior to 1986, citizens or domestic corporations which were entitled to the benefits of 26 USC § 931 (because they received a large amount of their income from within federal possessions). In determining taxable income, it is sometimes necessary to allocate deductions and expenses between income from the taxable activities, and non-taxable income from other activities.”*

(Note: This is a hypothetical regulation, not an actual regulation.)

This is close to what the older regulations stated. While there are a few more details to address than the above hypothetical regulation addresses, there is simply no justification for the thirty-some pages of jumbled mess that is currently found in the regulations under Section 861, including the needlessly twisted maze of “residual groupings,” “statutory groupings,” “specific sources,” “operative sections,” etc. (terms which do not appear anywhere in the statutes). The only plausible explanation for the current regulations is an intent to deceive.

### Tie-Breaker

The common “interpretation” of the income tax laws relies on multiple “assumptions,” as well as simply ignoring various sections which contradict those assumptions. Some may wish to imagine that some other “sources” of income which the law does not mention must also be taxable. Some may like to assume that everything is taxable unless the law specifically says it is not. And some may say that if there is some uncertainty about what the law requires, then the government by default “wins.” All of these are in direct conflict with a basic principle of tax law, which has been explained on numerous occasions by the Supreme Court.

*“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.*” [Gould v. Gould, 245 U.S. 151 (1917)]

*“In view of other settled rules of statutory construction, which teach that... if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer....”* [Hassett v. Welch, 303 U.S. 303 (1938)]

The extensive evidence of the correct, limited application of the income tax leaves little room for doubt. But even if the IRS, or others who would challenge the conclusions of this report, could obfuscate and confuse matters to the point where “it could go either way,” the Supreme Court makes it clear that such a disagreement is to be settled in favor of the citizen, **not** the government.

## 17) **Conclusion**

Because of the Constitution, Congress could not impose a tax on all income earned in the United States. What Congress did instead was to impose a tax on matters which they *could* tax (international and foreign commerce), and write the law in such a way that it would give the *impression* that it also applied to the income of most Americans. The Secretary of the Treasury wrote corresponding regulations with a similar goal: to tell the truth while implying a lie. Despite a longstanding and ongoing effort by some in government to confuse and obfuscate, the literal truth has remained in the law.

Though it is a complex process, the current statutes and regulations **by themselves** do reveal the limited application of the federal income tax laws. The older statutes and regulations then add extensive **reinforcement** and **clarity** to the conclusions reached by deciphering the current law. The historical documents also give ample evidence to justify an accusation, against the legislators in Congress and the authors of the regulations at the Department of the Treasury, of **intent to defraud** the American people of money not legally owed.

Aside from arguments about specific details, there is one giant hurdle for those who would still insist that most Americans receive taxable income: what is the alternate explanation that accounts for *every* citation in this report? There is extensive documentation, not only in the current statutes and regulations, but throughout more than 80 years of statutory and regulatory history, which supports the conclusions of this report.

It would be absurd to claim that a tax was imposed on the income of most Americans, and that by mistake or coincidence Congress and the Secretary put into the statutes and regulations such an enormous amount of information, spanning nearly a century, which indicates that the tax applies only to those engaged in international or foreign commerce. Quite simply, there is no conclusion other than the conclusion of this report which explains all of the evidence.



**Part I of Subchapter N, and the regulations thereunder:**

**STATUTES**

**REGULATIONS**

**Subchapter N - Tax based on income from sources within or without the United States**

**Part I - Determination of Sources of Income \***

**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...
- (2) Dividends...
- (3) Personal services - Compensation for labor or personal services...
- (4) Rentals and royalties...
- (5) Disposition of United States real property interest...
- (6) Sale or exchange of inventory property...
- (7) ...underwriting income...
- (8) Social security benefits...

**(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...**

- (c) Foreign business requirements...
- (d) Special rule for... subsection (a)(2)(B)...
- (e) Income from certain railroad rolling stock...
- (f) Cross reference...

(\* - See page 88 regarding the title of Part I of Subchapter N.)

**Part I - Income taxes**

**Determination of sources of income**

**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...** The statute provides for the following three categories of income:

- (1) **Within the United States.** The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a)... [plus part of 863 income] See Secs. 1.861-2 to 1.861-7, inclusive, and Sec. 1.863-1. The **taxable income from sources within the United States...** shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), [allowable deductions]... See Secs. **1.861-8** and 1.863-1.
- (2) Without the United States...
- (3) Partly within and partly without...

(b) **Taxable income from sources within the United States.** The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section... [plus part of (a)(3) income]

(c) Computation of income... [deals with income from both within and without U.S.]

**Sec. 1.861-2 Interest.**

**Sec. 1.861-3 Dividends.**

**Sec. 1.861-4 Compensation for labor or personal services.**

**Sec. 1.861-5 Rentals and royalties.**

**Sec. 1.861-6 Sale of real property.**

**Sec. 1.861-7 Sale of personal property.**

**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... 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...**

- (2) Allocation and apportionment of deductions...
- (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... of gross income enumerated in section 61, namely:... [lists items]
- (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.)**
- (5) Effective date...

(b) Allocation... [defines "class of gross income" again] See... **paragraph (d)(2) of this section which provides that a class of gross income may include excluded income.**

(c) Apportionment of deductions...

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

(2) Allocation and apportionment... [Reserved] For guidance, see Sec. **1.861-8T(d)(2).**

(e) Allocation and apportionment...

(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... [26 USC 904]
- (ii) [Reserved]
- (iii) **DISC and FSC taxable income...** [26 USC 925, 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)**...
- (v) **Foreign base company income...** [26 USC 954]
- (vi) Other operative sections. The rules provided in this section also apply in determining--  
(A) The amount of **foreign source items...**; (B) The amount of **foreign mineral income...**; (C) [Reserved]; (D) The amount of **foreign oil and gas...**; (E) The tax base for citizens **entitled to the benefits of section 931** and the section 936 tax credit...; (F) [about Puerto Rico]; (G) [about Virgin Islands]; (H) The income derived from **Guam...**; (I) [about China Trade Act]; (J) [about foreign corporations]; (K) [about insurance income of **foreign corporations**]; (L) The **international boycott factor...**; (M) [about Merchant Marine Act]...

(2) Application to more than one operative section....

(3) Special rules of section 863(b)

(i) In general...

(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...**

(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)...

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

(a) In general... (b) Allocation... (c) Apportionment of deductions...

(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...

(ii) Exempt income and exempt asset 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...**

(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...**
- (B) In computing the combined taxable income of a **DISC or FSC...**
- (C) For all purposes under subchapter N... the gross income of a **possessions corporation...**
- (D) **Foreign earned income** as defined in section 911 and the regulations thereunder...

(iv) Prior years....

(e) Allocation and apportionment of certain deductions...

(f) Miscellaneous matters--(1) Operative sections... [no list yet]... (g) [Reserved]...

Sec. 1.861-9T through 1.861-18 [allocation & special rules, income from aircraft & vessels, research, computer programs, etc.]

Part I of Subchapter N, and the regulations thereunder (continued):

STATUTES

REGULATIONS

<p><b>Sec. 862.</b> Income from sources <b>without</b> the United States...</p>	<p>Sec. 1.862-1 Income specifically from sources <b>without</b> the United States.                  (a) Gross income... [lists items of income]                  (b) Taxable income. The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in <b>Sec. 1.861-8 for determining the taxable income from sources within the United States.</b>                  (c) Income from certain property...</p>
<p><b>Sec. 863.</b> Special rules for determining source... [deals with income from sources partly within and partly without the United States]</p>	<p>Sec. 1.863-0 Table of contents...                  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)...                  (b) Natural resources...                  (c) Determination of taxable income. The taxpayer's <b>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.</b>                  (d) Scholarships, fellowship grants, grants, prizes and awards--                  (e) Effective dates...                  Sec. 1.863-2 through 1.863-5 [about allocation and apportionment, income from sales, transportation services, etc.]                  Sec. 1.863-6 Income from sources within a foreign country or possession of the United States.                  The principles applied in <b>Secs. 1.861-1 to 1.863-5</b>, inclusive, for <b>determining the gross and the taxable income from sources within and without the United States</b> shall generally be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States.                  Sec. 1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).</p>
<p><b>Sec. 864.</b> Definitions and special rules...</p>	<p>Sec. 1.864-1 through 1.864-8T [definitions]</p>
<p><b>Sec. 865.</b> [personal property sales]</p>	<p>Sec. 1.865-1T through 1.865-2T [Loss with respect to personal property]</p>

Predecessor of Part I of Subchapter N, and related regulations (1945)

STATUTES

REGULATIONS

Sec. 119. Income from sources within the United States  
 (a) Gross Income from Sources in 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, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including:...

(2) Dividends...

(3) Personal services. - Compensation for labor or personal services...

(4) Rentals and royalties...

(5) Sale of real property...

(6) Sale of personal property...

(b) Net Income from Sources in United States. - From the items of gross income specified in subsection (a) of this section there shall be deducted [allowable deductions]. **The remainder, if any, shall be included in full as net income from sources within the United States.**

(c) Gross Income from Sources **Without** United States...

(d) Net Income from Sources **Without** United States...

(e) Income from Sources **Partly Within and Partly Without** United States...

(f) Definitions...

Sec. 29.119-1. Income from sources within the United States.  
**Nonresident alien individuals, foreign corporations**, and citizens of the United States or domestic corporations **entitled to the benefits of section 251** [\*] are taxable only upon income from sources within the United States. Citizens of the United States and domestic corporations **entitled to the benefits of section 251** [\*] are, however, taxable upon income received within the United States, whether derived from sources within or without the United States. (See sections 212(a), 231(c), and 251.)  
 The Internal Revenue Code divides the income of **such taxpayers** into three classes:  
 (a) Income which is derived in full from sources within the United States;  
 (b) Income which is derived in full from sources without the United States;  
 (c) Income which is derived partly from sources within and partly from sources without the United States.  
 The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated or apportioned to sources within the United States.  
 Sec. 29.119-2. Interest. There shall be included in the gross income from sources within the United States, of **nonresident alien individuals, foreign corporations**, and citizens of the United States or domestic corporations which are **entitled to the benefits of section 251** [\*], all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:...

Sec. 29.119-3. Dividends...

Sec. 29.119-4. Compensation for labor or personal services...

Sec. 29.119-5. Rentals and royalties...

Sec. 29.119-6. Sale of real property...

Sec. 29.119-7. Income from sources without the United States...

Sec. 29.119-8. Sale of personal property...

Sec. 29.119-9. Deductions in general.  
 The deductions provided for in chapter 1 shall be allowed to **nonresident alien individuals and foreign corporations** engaged in trade or business within the United States, and to citizens of the United States and domestic corporations **entitled to the benefits of section 251** [\*], only if and to the extent provided in sections 213, 215, 232, 233, and 251.  
 Sec. 29.119-10. Apportionment of deductions.  
 From the items specified in sections 29.119-1 to 29.119-6, inclusive, as being derived specifically from sources within the United States there shall, in the case of **nonresident alien individuals and foreign corporations** engaged in trade or business within the United States, be deducted [allowable deductions]. **The remainder shall be included in full as net income from sources within the United States.**

[\* - One can be entitled to the benefits of section 251 only if he receives a certain percentage of his income from within federal possessions.]

## ***Operation Honest Inquiry:***

### **Questions regarding the proper application of the Federal Income Tax**

Please supply me with specific written answers to the following questions. (The enclosed “Exhibits” are from the Code of Federal Regulations, and only the page headers and underline emphasis have been added.)

1) **Are 26 USC § 861(b), and the related regulations beginning at 26 CFR § 1.861-8, the sections to use to determine one’s taxable income from sources within the United States?** If not, please provide citations showing that some individuals should **not** use 26 USC § 861(b), and the related regulations beginning at 26 CFR § 1.861-8, to determine their taxable income from sources within the United States, despite the citations shown in the attached “Exhibit A.”

(Note: Many sections of the Code deal with the inclusion or exclusion, or the special treatment of certain “items” of income, and the previous question is **not** asking whether 26 USC § 861(b) and 26 CFR § 1.861-8 nullify such special rules.)

2) **When a U.S. citizen lives and works exclusively within the 50 states, and derives all of his income from within the 50 states, do 26 USC § 861(b), and the related regulations beginning at 26 CFR § 1.861-8, show such income to be taxable?** (See the attached “Exhibit B.”)

3) **Should one refer to 26 CFR § 1.861-8T(d)(2) to determine in which situations the “items” of income listed in 26 USC § 61 are excluded for federal income tax purposes?** If not, please supply an explanation of the emphasized citations in the attached “Exhibit C.”

## EXHIBIT A, Page 1 (26 CFR § 1.861-1)

### Internal Revenue Service, Treasury

### § 1.861-1

in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. The day so designated is then the startup day, and all interests are treated as issued on that day.

[T.D. 8458, 57 FR 61309, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

#### § 1.860G-3 Treatment of foreign persons.

(a) *Transfer of a residual interest with tax avoidance potential*—(1) *In general.* A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) *Tax avoidance potential*—(i) *Defined.* A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) *Safe harbor.* For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) *Effectively connected income.* Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) *Transfer by a foreign holder.* If a foreign person transfers a residual interest to a United States person or a

foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for purposes of section 871(a), 881, 1441, or 1442.

(b) [Reserved]

[T.D. 8458, 57 FR 61313, Dec. 24, 1992]

#### TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

##### DETERMINATION OF SOURCES OF INCOME

#### § 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. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely

## EXHIBIT A, Page 2 (26 CFR § 1.861-1, continued)

### § 1.861-2

### 26 CFR Ch. I (4-1-99 Edition)

be allocated to some item or class of gross income. See §§ 1.861-8 and 1.863-1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.862-1 and 1.863-1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862-1 and 1.863-1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863(b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863-2 to 1.863-5, inclusive.

(4) *Exceptions.* An owner of certain aircraft or vessels first leased on or before December 28, 1980, may elect to treat income in respect of these aircraft or vessels as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861-9. An owner of certain aircraft, vessels, or spacecraft first leased after December 28, 1980, must treat income in respect of these craft as income from sources within the United States for purposes of sections 861(a) and 862(a). See § 1.861-9A.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a)(1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a)(3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States,

together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7928, 48 FR 55845, Dec. 16, 1983]

#### § 1.861-2 Interest.

(a) *In general.* (1) Gross income consisting of interest from the United States or any agency or instrumentality thereof (other than a possession of the United States or an agency or instrumentality of a possession), a State or any political subdivision thereof, or the District of Columbia, and interest from a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States. Thus, for example, income from sources within the United States includes interest received on any refund of income tax imposed by the United States, a State or any political subdivision thereof, or the District of Columbia. Interest other than that described in this paragraph is not to be treated as income from sources within the United States. See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

(2) The term "resident of the United States", as used in this paragraph, includes (i) an individual who at the time of payment of the interest is a resident of the United States, (ii) a domestic corporation, (iii) a domestic partnership which at any time during its taxable year is engaged in trade or business in the United States, or (iv) a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States.

(3) The method by which, or the place where, payment of the interest is made is immaterial in determining whether interest is derived from sources within the United States.

## EXHIBIT A, Page 3 (26 CFR § 1.861-8)

### Internal Revenue Service, Treasury

### § 1.861-8

brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States. For taxable years beginning after December 31, 1966, gains described in section 871(a)(1)(D) and section 881(a)(4) from the sale or exchange after October 4, 1966, of patents, copyrights, and other like property shall be treated, as provided in section 871(e)(2), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See paragraph (e) of §1.871-11.

[T.D. 7378, 40 FR 45434, Oct. 2, 1975]

#### § 1.861-6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

#### § 1.861-7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863(b)(3) and §1.863-2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a

sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§1.863-1 and 1.863-2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306(f) and the regulations thereunder.

#### § 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

## EXHIBIT A, Page 4 (26 CFR § 1.863-1)

### Internal Revenue Service, Treasury

### § 1.863-1

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 liquified in preparation 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 liquified 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 § 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 § 1.863-3. If US Gold applies the 50/50 method described in § 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 cir-

cumstances, 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 ~~§§ 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 this section, 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.

## EXHIBIT B, Page 1 (26 CFR § 1.861-1)

### Internal Revenue Service, Treasury

### § 1.861-1

in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. The day so designated is then the startup day, and all interests are treated as issued on that day.

[T.D. 8458, 57 FR 61309, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993]

#### § 1.860G-3 Treatment of foreign persons.

(a) *Transfer of a residual interest with tax avoidance potential*—(1) *In general.* A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) *Tax avoidance potential*—(i) *Defined.* A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) *Safe harbor.* For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) *Effectively connected income.* Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) *Transfer by a foreign holder.* If a foreign person transfers a residual interest to a United States person or a

foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for purposes of section 871(a), 881, 1441, or 1442.

(b) [Reserved]

[T.D. 8458, 57 FR 61313, Dec. 24, 1992]

#### TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

##### DETERMINATION OF SOURCES OF INCOME

#### § 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. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely

## EXHIBIT B, Page 2 (26 CFR § 1.861-8(f)(3)(ii))

### Internal Revenue Service, Treasury

### § 1.861-8

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 §§ 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

## EXHIBIT B, Page 3 (26 CFR § 1.861-8(f)(1))

### Internal Revenue Service, Treasury

### § 1.861-8

(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 §§ 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 re-

lated 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 § 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.

## EXHIBIT B, Page 4 (26 CFR § 1.861-8(f)(1), continued)

### § 1.861-8

26 CFR Ch. I (4-1-00 Edition)

(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 §§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

## EXHIBIT C, Page 1 (26 CFR § 1.61-1)

### § 1.61-1

1.168A-4 Definitions.  
1.168A-5 Adjusted basis of emergency facility.  
1.168A-6 Depreciation of portion of emergency facility not subject to amortization.  
1.168A-7 Payment by United States of unamortized cost of facility.  
1.169-1 Amortization of pollution control facilities.  
1.169-2 Definitions.  
1.169-3 Amortizable basis.  
1.169-4 Time and manner of making elections

AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.  
Section 1.61-2T also issued under 26 U.S.C. 61.  
Section 1.61-21 also issued under 26 U.S.C. 61.  
Sections 1.62-1T and 1.62-2 also issued under 26 U.S.C. 62;  
Sections 1.67-2T and 1.67-3T also issued under 26 U.S.C. 67(c);  
Section 1.67-3 also issued under 26 U.S.C. 67(c).  
Sections 1.72-4, 1.72-5, 1.72-6, 1.72-7, 1.72-8, and 1.72-11 also issued under 26 U.S.C. 72(c).  
Section 1.101-7 also issued under 26 U.S.C. 101(d)(2)(B)(ii);  
Section 1.103-10 also issued under 26 U.S.C. 103(b)(6);  
Section 1.103A-2 also issued under 26 U.S.C. 103A(j);  
Section 1.108-1 also issued under 26 U.S.C. 108(e)(8) and 108(e)(10)(B);  
Section 1.108-2 also issued under 26 U.S.C. 108;  
Section 1.108-3 also issued under 26 U.S.C. 108, 267, and 1502.  
Section 1.108-4 also issued under 26 U.S.C. 108.  
Section 1.108-5 also issued under 26 U.S.C. 108.  
Section 1.108(c)-1 also issued under the authority of 26 U.S.C. 108(d)(9);  
Sections 1.132-0 through 1.132-8T also issued under 26 U.S.C. 132;  
Sections 1.148-0 through 1.148-11 also issued under 26 U.S.C. 148 (f), (g), and (i);  
Sections 1.148-6 also issued under 26 U.S.C. 148 (f), (g), and (i);  
Section 1.149(b)-1 also issued under 26 U.S.C. 149(b)(3)(B) (v);  
Section 1.149(d)-1 also issued under 26 U.S.C. 149(d)(7);  
Section 1.149(e)-1 also issued under 26 U.S.C. 149(e);  
Section 1.149(g)-1 also issued under 26 U.S.C. 149(g)(5);  
Sections 1.150-4 also issued under 26 U.S.C. 150 (c)(5);  
Section 1.163-8T also issued under 26 U.S.C. 469(k)(4);  
Section 1.163-9T also issued under 26 U.S.C. 163(h)(3)(D);  
Section 1.163-11T is also issued under 26 U.S.C. 163(h);

### 26 CFR Ch. I (4-1-00 Edition)

Section 1.165-12 also issued under 26 U.S.C. 165(j)(3);  
Section 1.166-10 also issued under 26 U.S.C. 166(f);  
Section 1.168(d)-1 also issued under 26 U.S.C. 168(d)(3);  
Section 1.168(f)(8)-1T also added under sec. 112(c), Black Lung Benefits Revenue Act of 1981 (Pub. L. 97-119);  
Section 1.168(h)-1 also issued under 26 U.S.C. 168.  
Section 1.168(i)-1 also issued under 26 U.S.C. 168(i)(4).  
Section 1.168(i)-2 also issued under 26 U.S.C. 168.  
Section 1.168(j)-1T also added under 26 U.S.C. 168(j)(10);

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

### COMPUTATION OF TAXABLE INCOME

DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, AND TAXABLE INCOME

#### § 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, § 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.

## EXHIBIT C, Page 2 (26 CFR § 1.861-8(a))

### § 1.861-8

### 26 CFR Ch. I (4-1-00 Edition)

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)

## EXHIBIT C, Page 3 (26 CFR § 1.861-8(b))

### Internal Revenue Service, Treasury

### § 1.861-8

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, § 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 § 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.

## EXHIBIT C, Page 4 (26 CFR § 1.861-8(d)(2))

### § 1.861-8

26 CFR Ch. I (4-1-00 Edition)

(3) *Supportive functions.* [Reserved] For guidance, see § 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 § 1.861-8T(c)(1).

(2) *Apportionment based on assets.* [Reserved] For guidance, see § 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 § 1.1502-4(d)(1) and the last sentence of § 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 § 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

## EXHIBIT C, Page 5 (26 CFR § 1.861-8T(d)(2))

### § 1.861-8T

26 CFR Ch. I (4-1-00 Edition)

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 § 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 § 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 § 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 § 1.1502-13 in determining gain or loss from intercompany transactions, as defined in § 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 asset 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 § 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 § 1.861-10T(c), and in the apportionment of other expenses under the consolidation rules set forth in § 1.861-14T.

EXHIBIT C, Page 6 (26 CFR § 1.861-8T(d)(2), continued)

Internal Revenue Service, Treasury

§ 1.861-8T

(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 §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 §1.861-13T, see §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 §§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.

(iii) [Reserved]

(2)–(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