

Part I

Section 3401.—Definitions

[26 CFR 31.3401(c)-1]: Employee
(Also: 26 CFR 31.3401(a)-1)

Rev. Rul. 2006-18

PURPOSE

The Service is aware that some taxpayers are claiming that only federal employees and persons residing in Washington, D.C. or federal territories and enclaves are subject to federal tax. These taxpayers may attempt to avoid their federal tax liability by submitting a Form 4852 (Substitute for W-2, Wage and Tax Statement) to the Internal Revenue Service with a zero on the line for the amount of wages received. These taxpayers may also file tax returns showing no income and claiming a refund for withheld income taxes. The Service is also aware that some promoters market a book, package, kit or other materials that claim to show taxpayers how they can avoid paying income taxes based on this and other meritless arguments.

This revenue ruling emphasizes to taxpayers, promoters, and return preparers that all individuals are subject to federal income tax. This revenue ruling also provides

that the terms “employee” and “wages” carry the meanings given to them in the Internal Revenue Code, regulations, and publications of the Internal Revenue Service. Under the Internal Revenue Code, wages include any compensation received due to the performance of services as an employee, and the term employee includes any individual for whom the legal relationship between the individual and the person for whom the individual performs services is the legal relationship of employer and employee. All wages are included in gross income for purposes of determining federal income tax liability, and are also subject to federal employment taxes. Any argument that Forms W-2 only record and report payments made to federal employees, or that only federal employees or residents of the District of Columbia or federal territories and enclaves earn wages subject to tax, has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through the Service’s Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns, and computes the correct amount of tax and interest due, and determines whether civil or criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether an injunction should be sought to

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

ISSUE

Whether only federal employees and persons residing in Washington, D.C. or federal territories and enclaves are subject to federal income and employment taxes.

FACTS

Taxpayer A either 1) requests, by submitting a Form W-4, Employees Withholding Allowance Certificate, that his employer not withhold any amount of federal tax from wages earned, or 2) prepares a Form 4852 (Substitute for W-2) showing no wages received. In addition, taxpayer A either fails to file a return, or files a return with zero income claiming all withholding as a refund. Taxpayer A claims that he is not an “employee” and does not receive “wages” subject to federal income tax, as those terms are as defined in the Internal Revenue Code. Taxpayer A contends that the federal government can only legally demand an “income” tax from federal employees and persons residing in Washington, D.C. or federal territories and enclaves. Therefore, Taxpayer A claims that he does not have to pay “income” taxes – which Taxpayer A asserts also include employment taxes such as Federal Insurance Contributions Act (FICA) taxes – to the federal government.

LAW AND ANALYSIS

Section 3401(a) provides that “wages” include all remuneration for services performed by an employee for his employer. Section 3121(a) provides a similar

definition of wages for FICA tax purposes. The argument that only federal employees and persons residing in Washington, D.C. or federal territories and enclaves are subject to tax is based on a misinterpretation of section 3401(c), which defines “employee” and states that the term “includes an officer, employee or elected official of the United States, a State, or any political subdivision thereof” Section 31.3401(c)-1 of the Employment Tax Regulations provides that the term “employee” includes every individual performing services if the relationship between that individual and the person for whom he performs such services is the legal relationship of employer and employee. Section 7701(c) states that the use of the word “includes” “shall not be deemed to exclude other things otherwise within the meaning of the term defined.” Thus, the word “includes” as used in the definition of “employee” under § 3401(c) is a term of enlargement, not of limitation. Courts have recognized that federal employees and officials are among those within the definition of “employee,” which also includes private citizens. See Sullivan v. United States, 788 F.2d 813, 815 (1st Cir. 1986) (contention that taxpayer was not an “employee” is meritless, section 3401(c) does not limit withholding to the persons listed therein); United States v. Latham, 754 F.2d 747, 750 (7th Cir. 1985) (under section 3401(c), the category of “employee” includes privately employed wage earners; the word “includes” is a term of enlargement not of limitation, and the reference to certain entities or categories is not intended to exclude all others); Pabon v. Commissioner, T.C. Memo. 1994-476 (1994) (taxpayer’s frivolous position that she was not subject to tax because she was not an employee of the federal or state governments warranted sanctions of \$2,500).

The employment tax withholding provisions do not affect whether wages are gross income. Section 61 provides that compensation for services is includable in gross income. Whether the compensation for services is in the form of wages, or in some other form, is irrelevant. The amount is still subject to income tax. All employees, not just federal employees and those living in federal territories and enclaves, are subject to income and employment taxes.

HOLDING

Federal income tax laws do not apply solely to federal employees and persons residing in the District of Columbia, or federal territories and enclaves, and any contrary contention is frivolous. The terms “employee” and “wages” as used by the Internal Revenue Code apply to all employees, unless specifically exempted by the Internal Revenue Code. The income tax withholding provisions do not affect whether an amount is gross income.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who attempt to avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay tax based on the argument that Forms W-2 only record and report payments made to federal workers, or that only federal employees or residents of federal territories and enclaves earn wages, face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil

fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a \$500 penalty imposed under section 6702 when the taxpayer files a document that purports to be a return but that contains a frivolous position or suggests a desire by the taxpayer to delay or impede the administration of Federal income tax laws; (4) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; and (5) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

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

Persons, including return preparers, who promote this frivolous position and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a \$250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who knew or should have known that the taxpayer's position was frivolous (or \$1,000 for each return or claim for refund if the return preparer's actions were willful, intentional or reckless); (2) a penalty under section 6700 for promoting abusive tax shelters; (3) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax;

and (4) criminal prosecution under section 7206, for which the penalty is a significant fine and imprisonment for up to 3 years, for assisting or advising about the preparation of a false return, statement or other document under the internal revenue laws.

DRAFTING INFORMATION

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