

Section 6662.—Imposition of Accuracy-Related Penalty

Frivolous tax returns; meritless “claim of right” arguments. This ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with frivolous tax schemes, that there is no “claim of right” doctrine that permits an individual to take the position that either the individual or the individual’s income is not subject to federal income tax. The ruling also describes many of the possible civil and criminal penalties that apply to people who make frivolous “claim of right” arguments to evade tax.

Rev. Rul. 2004–29

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by taking the position that either they or their incomes are not subject to tax based on what they describe or refer to as a “claim of right.” The Service also is aware that promoters, including return preparers, are advising or recommending that taxpayers take frivolous positions based on this argument. Some promoters may be marketing a 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, and to promoters and return preparers who assist taxpayers with this scheme, that there is no “claim of right” doctrine that permits an individual to take the position that either the individual or the individual’s income is not subject to federal income tax. This argument has no merit and is frivolous. Section 1341 (“Computation of tax where taxpayer restores substantial amount held under claim of right”) of the Internal Revenue Code applies only when a taxpayer properly reports an amount of income in one taxable year and later repays all or a portion of that same amount in a later taxable year because the taxpayer, in fact, did not have an unrestricted right to that income.

The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions, such as frivolous positions based on

a meritless “claim of right” argument. 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 its Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and 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 a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether section 1341, relating to amounts “held under claim of right,” allows an individual to reduce his or her federal income tax liability with respect to an item that was not included in gross income for a prior taxable year.

FACTS

Individual taxpayer A has gross income for taxable year 1. A claims deductions that equal or exceed A’s gross income on A’s individual income tax return for taxable year 1. A’s claimed deductions may appear on various places on the return. For example, A may claim the deductions: (i) on Schedule A as compensation for personal labor; (ii) on Schedule C as a cost of A’s labor; or (iii) on other schedules or elsewhere on A’s return. Alternatively, A simply may not report all or some of A’s gross income on A’s return. Although the specific nature of A’s “claim of right” argument for the position taken on the return may vary, A’s position generally is that under a “claim of right,” either A or A’s income, or both, are not subject to federal income taxes.

No portion of A’s claimed deductions, or the amount of A’s gross income not reported on the return, was included in A’s gross income in any prior taxable year.

LAW AND ANALYSIS

Section 1341 governs the computation of income tax if: (i) an amount of income was included in a taxpayer's gross income in a prior year(s) because it appeared that the taxpayer had an unrestricted right to such item; and (ii) a deduction exceeding \$3,000 is allowable in the current taxable year because, after the close of such prior taxable year, it is established that the taxpayer did not have an unrestricted right to all or a portion of such item of income. There is no "claim of right" doctrine under U.S. law, including the Internal Revenue Code, that permits an individual to take the position that either the individual or the individual's income is not subject to federal income tax.

Individuals such as Taxpayer A who make meritless "claim of right" arguments do not purport to have repaid amounts previously reported as income, but instead simply claim that either they or their incomes are not subject to tax. In many respects, the so-called "claim of right" argument being made by these taxpayers is no different than the argument that some taxpayers have made that compensation for personal services is not subject to taxation. Courts repeatedly have rejected these types of arguments as frivolous and have penalized taxpayers who make these types of arguments. *See, e.g., Stelly v. Commissioner*, 761 F.2d 1113, 1115 (5th Cir. 1985) (finding that the argument that taxing wage and salary income is unconstitutional because compensation for labor is an even exchange is obviously frivolous); *Abrams v. Commissioner*, 82 T.C. 403, 413 (1984) (rejecting argument that wages are not subject to the imposition and collection of tax as frivolous and groundless and imposing a \$5,000 penalty under section 6673).

CIVIL AND CRIMINAL PENALTIES

The Service will disallow deductions or other claimed tax benefits, including the exclusion of income, based on frivolous "claim of right" arguments. In addition to liability for tax due plus statutory interest, individuals who claim tax benefits on their returns based on this and other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalty, which

is equal to 20 percent of the amount of taxes 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 under section 6702 for filing a frivolous return; and (4) 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 scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 5 years; or (2) making false statements on a return under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a \$250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or \$1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

Any claim that a taxpayer can use a "claim of right" argument to reduce the taxpayer's federal income tax liability with respect to any item not included in gross income for a prior tax year is frivolous. Taxpayers attempting to reduce their federal tax liability by taking frivolous positions based on this argument will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against taxpayers where appropriate, and those taxpayers also may face criminal prosecution. The Service also will determine appropriate civil penal-

ties against persons who prepare frivolous returns or promote frivolous positions, and those persons also may face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of 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).