BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
DONALD W. BARNES, TO ASSESSMENT **No. 05-22**
OF 1999 PERSONAL INCOME TAX ISSUED
UNDER LETTER ID L1666721792

ORDER GRANTING DEPARTMENT'S MOTION FOR SUMMARY JUDGMENT AND DENYING TAXPAYER'S PROTEST

This matter comes before the Hearing Officer on the Taxation and Revenue Department's September 22, 2005 Motion for Summary Judgment. Donald W. Barnes did not file a response. Based on a review of the pleadings filed in this case, the Hearing Officer finds that there is no genuine issue as to any material fact and that the Department is entitled to judgment as a matter of law.

FINDINGS OF FACT

1. In 1988, the Department entered into an Agreement on Coordination of Tax Administration with the Internal Revenue Service.

2. In 1989 and again in 1999, the Department entered into an Implementation Agreement (Exhibit B to the Motion for Summary Judgment) to the 1988 coordination agreement. The first paragraph of the Implementation Agreement states as follows:

> Under the authority of Section 6103(d) of the Internal Revenue Code, as amended, the New Mexico Taxation and Revenue Department, the Commissioner of Internal Revenue Service adopted an Agreement on Coordination of Tax Administration. This Agreement constitutes the requisite authorization for the Internal Revenue Service and the Department to exchange tax returns and return information and is currently in full force and effect.

The body of the agreement sets out the type of information that will be exchanged between the IRS and Department on a monthly basis, including examination reports with respect to individual income tax adjustments that result in additional federal tax above a specified amount.[1]

3. In 2003, the IRS provided the Department with tax information concerning Donald Barnes via federal form 4549, titled "Income Tax Examination Changes," which is generally referred to as a Revenue Agent Report ("RAR") (Exhibit A to Motion for Summary Judgment).

4. Based on its examination, the IRS adjusted Mr. Barnes' 1999 gross income from zero to $29,624, representing $29,593 of non-employee compensation ("NEC") from Otero Enterprises Incorporated and $31 of interest from Conseco Medical Insurance Company.

5. After applicable deductions and exemptions, Mr. Barnes' taxable income was adjusted to $21,183, resulting in additional federal income tax of $3,176, plus $4,181 of self-employment tax, for a total corrected federal tax liability of $7,357.

6. The RAR on Mr. Barnes included the following statement: "The Internal Revenue Service has agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the State form."

7. Mr. Barnes did not file a 1999 New Mexico personal income tax return reporting the taxable income shown on the RAR.

[1] The Department submitted a redacted copy of the Implementation Agreement with threshold amounts of additional tax needed to trigger the exchange of information deleted. Presumably, this was done to avoid alerting taxpayers to the level of underreported tax that will escape detection through the Department's information exchange program with the IRS. Without deciding whether such deletions come within any recognized confidentiality provision, I find that the deleted information is not necessary to a resolution of the issues raised in this administrative protest.

8. On October 24, 2003, the Department issued an assessment under Letter ID No. L0391334912 assessing Mr. Barnes for $946.00 of 1999 personal income tax, plus interest and penalty accrued to the date of assessment.

9. On November 13, 2003, Mr. Barnes filed a written protest to the assessment.

DISCUSSION

Mr. Barnes' November 13, 2003 Petition of Protest challenges the Department's assessment on three grounds: (1) that the "domestic income" Mr. Barnes received during 1999 is not subject to federal or state income tax because it was not derived from a source listed in the regulations to 26 CFR § 861; (2) that only the Secretary of the United States Treasury or his delegate has authority to determine a taxpayer's liability for federal and state income tax; and (3) that the information exchanged between the IRS and the Department is based upon fraud and errors.

In *Fikes v. Furst*, 2003 NMSC 33, ¶ 11, 134 N.M. 602, 81 P.3d 545, the New Mexico Supreme Court set out the following standard for reviewing a motion for summary judgment:

> Summary judgment is the appropriate disposition if "there is no genuine issue as to any material fact and ... the moving party is entitled to a judgment as a matter of law." Rule 1-056(C) NMRA 2003. "Summary judgment may be proper even though some disputed issues remain, if there are sufficient undisputed facts to support a judgment and the disputed facts relate to immaterial issues." *Oschwald v. Christie*, 95 N.M. 251, 253, 620 P.2d 1276, 1278 (1980). Once the movant makes a prima facie case that summary judgment should be granted, the burden "shifts to the opponent to show at least a reasonable doubt, rather than a slight doubt, as to the existence of a genuine issue of fact." *Ciup v. Chevron U.S.A., Inc*., 1996 NMSC 62, P7, 122 N.M. 537, 928 P.2d 263.

See also, Madsen v. Scott, 1999 NMSC 42, ¶ 7, 128 N.M. 255, 992 P.2d 268; *Roth v. Thompson*, 113 N.M. 331, 335, 825 P.2d 1241, 1245 (1992). Based on the pleadings submitted by the parties in this case, there are no genuine issues of material fact in dispute. As set forth below, the

resolution of Mr. Barnes' protest rests entirely on interpretation of federal and state law, and summary judgment is appropriate.

Issue One: **Whether Mr. Barnes' 1999 income is subject to New Mexico income tax**. The RAR provided to the Department establishes that Mr. Barnes received $29,593 of non-employee compensation from Otero Enterprises Incorporated and $31 of interest from Conseco Medical Insurance Company during the 1999 tax year. Mr. Barnes has not submitted any evidence to dispute the income amounts shown on the RAR. In his Petition of Protest (at page 7), Mr. Barnes acknowledged that he had "domestic income within the United States" during 1999, but argued that this income is not subject to federal (and by extension, New Mexico) income tax because it was not derived from a taxable source. In making his argument, Mr. Barnes begins with 26 U.S.C. § 61(a) of the Internal Revenue Code, which defines "gross income" as follows:

> (a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
> (2) Gross income derived from business;
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;
> (6) Royalties;
> (7) Dividends;
> (8) Alimony and separate maintenance payments;
> (9) Annuities;
> (10) Income from life insurance and endowment contracts;
> (11) Pensions;
> (12) Income from discharge of indebtedness;
> (13) Distributive share of partnership gross income;
> (14) Income in respect of a decedent; and
> (15) Income from an interest in an estate or trust.

This definition is quite broad, and certainly appears to include the non-employee compensation and interest Mr. Barnes received during 1999. He nonetheless disputes the applicability of § 61 to his income, arguing that this section defines only "items" of income, and that an item of income is not the same as a source of income. Mr. Barnes has determined that the only section of the Internal Revenue Code defining sources of income is 26 U.S.C. § 861. He has further concluded that only income from sources set out in the regulations at 26 CFR § 1.861-8 is subject to federal income tax. Because Mr. Barnes' 1999 "domestic income" does not come within the purview of those regulations, he has concluded that this income is not subject to tax.

The argument Mr. Barnes raises, which is generally known of the "section 861 argument" or the "U.S. Sources argument." is not new. The federal courts have addressed—and universally rejected—this argument on numerous occasions. *See, e.g.*, *United States v. Bell*, 238 F.Supp.2d 696, 701 (M.D. Pa. 2003), *modified*, 414 F.3d 474 (3d Cir. 2005) (to suggest that the regulations under § 861 create an exemption for domestic wages of U.S. citizens "is irresponsible and frivolous advocacy"); *Loofbourrow v. Comm'r of Internal Revenue*, 208 F.Supp.2d 698, 709 (S.D. Tex. 2002) (plaintiff's § 861 argument "is without factual or legal basis"); *Johnson v. United States*, 291 F.Supp.2d 1163, 1166 (D. Cal. 2003) (assertions that §§ 861-865 and related regulations define or limit the definition of gross income are frivolous); *Dashiell v. Comm'r of Internal Revenue*, T.C. Memo 2004-210 (2004) (courts which have addressed the § 861 argument have rejected it as frivolous); *Corcoran v. Comm'r of Internal Revenue,* T.C. Memo 2002-18, *aff'd* 54 Fed. Appx. 254 (9th Cir. 2002), *cert. denied*, 123 S.Ct. 2105 (2003) (the source rules of §§ 861-865 do not exclude from taxation income earned by U.S. citizens from sources within the United States); *Williams v. Comm'r of Internal Revenue*, 114 T.C. 136, 138 (U.S. Tax Court

2000) (petitioner's § 861 arguments "are reminiscent of tax-protester rhetoric that has been universally rejected by this and other courts").

In recent years, federal courts have begun enjoining tax preparers and others who promote the § 861 argument for profit. *See, e.g.*, *United States v. Bell*, 414 F.3d 474 (3d Cir. 2005); *United States v. Cohen*, 2005 U.S. Dist. LEXIS 17606 (D. Wash. 2005); *United States v. Bosset*, 2003 U.S. Dist. LEXIS 7947 (D. Fla. 2003); *United States v. Farnell*, 2003 U.S. Dist. LEXIS 2096 (D. Fla. 2003). In Revenue Ruling 2004-30, issued on March 22, 2004, the IRS specifically warned taxpayers and tax preparers that filing returns based on the § 861 argument could result in civil and criminal penalties:

> This revenue ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with this scheme, that there is no authority in sections 861 through 865 that permits an individual to take the position that either the individual or the individual's U.S.-based income is not subject to federal income tax. This argument has no merit and is frivolous….
>
> The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions, such as the Section 861 position. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions….

A discussion of the § 861 argument also appears in the IRS's web-based publication entitled *Anti-Tax Law Evasion Schemes* (found at www.irs.gov).

In *Dashiell, supra*, the United States Tax Court noted that "most courts would not dignify petitioners' particular tax protester argument by addressing it at length in a written court opinion." Nonetheless, the court decided to provide the taxpayers in that case with a full analysis of their § 861 argument "with the hope that petitioners will consider themselves personally addressed, that they will consider themselves to have had their day in court, and that petitioners

will find such explanation persuasive and convincing and will come back into compliance with the Federal income tax system." With a similar hope, the *Dashiell* court's analysis is set out below for Mr. Barnes' review:

> With regard to the definition of income, section 61 expressly states that gross income constitutes "all income" and expressly lists as one of the categories of income "compensation for services" rendered by the taxpayer, which certainly would include Gary's wages as a salesman and any fee income Fran received for computer consulting. Sec. 61(a)(1). Also, section 61(a)(4) expressly lists "interest," which certainly would include interest income petitioners received in 1997.
>
> Section 1.1-1, Income Tax Regs., provides further as follows:
>
> > 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 * * *.
> > * * * *
> > (b) Citizens or residents of the United States liable to tax. In general, all citizens of the United States, wherever resident, * * * are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. * * *
>
> The Supreme Court has defined income under section 61 broadly, noting that Congress intended to tax as income "all gains except those specifically exempted." *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426, 429-430, 99 L. Ed. 483, 75 S. Ct. 473 (1955).
>
> In *Commissioner v. Schleier*, 515 U.S. 323, 327-328, 132 L. Ed. 2d 294, 115 S. Ct. 2159 (1995), the Supreme Court noted that because of the broad and inclusive nature of section 61(a), an income item must be included in income for Federal income tax purposes unless it is explicitly excluded by another provision of the Code.
>
> Petitioners point out that section 61(a) uses the word "source" but that section 61 does not go on to define the "sources" which produce income taxable by the United States. Petitioners therefore conclude that in order to identify the "sources" of income that are taxable reference must be made to the income "sourcing" rules of sections 861-865 and to respondent's regulations thereunder, specifically section 1.861-8(f)(1), Income Tax Regs.

Petitioners misread section 61. That section prefaces its use of the word "source" by the word "whatever", thereby making the particular source of a U.S. taxpayer's income (and the income sourcing rules of sections 861-865) irrelevant for purposes of the definition of income under section 61. The precise language of section 61(a) provides as follows:

> Except as otherwise provided in this subtitle, gross income means all income from *whatever source* derived, including (but not limited to) * * *. [Emphasis supplied.]

It is helpful to read carefully the specific language from the regulations under section 861 on which petitioners rely. The introductory language of section 1.861-8(f)(1), Income Tax Regs., states as follows:

> (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. [Emphasis added.]

As we have explained, section 61 does not "require the determination of petitioners' taxable income from specific sources". Rather, section 61 explicitly states that petitioners' income from "whatever" source constitutes income under section 61. Therefore, since section 61 is not one of the "operative sections" which require "specific" sourcing of items of income, section 61 is not affected by section 1.861-8(f)(1), Income Tax Regs.

As the Court of Claims has explained:

> The determination of where income is derived or "sourced" is generally of no moment to either United States citizens or United States corporations, for such persons are subject to tax under section 1 and section 11, respectively, on their worldwide income. * * * [*Great-West Life Assur. Co. v. United States*, 230 Ct. Cl. 477, 482, 678 F.2d 180, 183 (1982).]

Petitioners' narrow reading of section 61, under which the definition of income for purposes of section 61 would be limited by the section 861 source-of-income rules, is without any legal support and is erroneous….

Issue Two: **Whether New Mexico Has the Legal Authority to Assess and Collect State Taxes Independently of the IRS**. As the second basis for his protest to the Department's assessment, Mr. Barnes argues that only the Secretary of the United States Treasury or his delegate

has the authority to determine state income tax. Petition of Protest at pages 9-10. Mr. Barnes bases his argument on 26 CFR § 1.6001-1(a) and (d), which authorize IRS district directors to require "any person subject to tax under Subtitle A of the Code (including a qualified state individual income tax which is treated pursuant to section 6361(a) as if it were imposed by Chapter 1 of Subtitle A)" to maintain permanent books of account and other records sufficient to establish the amount of gross income, deductions, and credits reported on a return. Mr. Barnes misconstrues these federal regulations—which deal solely with record retention requirements—to mean that all assessments of tax must be made by district directors. Mr. Barnes also misconstrues the reference to "qualified state individual income tax" to mean that only the federal government has authority to determine and assess state income tax.

The term "qualified state individual income tax" originated with the Federal-State Tax Collection Act of 1972, 26 U.S.C. §§ 6361-6365, which was designed to encourage states to conform their personal income tax structure to that of the federal government. In furtherance of this goal, the Act provided that a state with a "qualified state individual income tax," *i.e.*, a tax closely conforming to the model of the federal income tax, could enter into an agreement to have the state's individual income taxes collected and administered by the federal government. As noted in W. Hellerstein, *Symposium on State and Local Taxation*, 39 Vand. L. Rev. 1033, 1055 n. 31 (May 1986), none of the states chose to enter into such an agreement. Sections 6361-6365 were subsequently repealed in November 1990, nine years prior to the tax year at issue in Mr. Barnes' protest. Public Law 101-508, Title XI, § 11801(a)(45), 104 Stat. 1388-522.

In *Franchise Tax Board v. United States Postal Service*, 467 U.S. 512 (1984), the United States Supreme Court addressed the scope of §§ 6361-6365 in deciding a challenge to

California's authority to require the Postal Service to comply with the Franchise Tax Board's orders to withhold delinquent state income tax from employee wages. One of the arguments raised by the Postal Service was that Congress intended states to use the provisions for collecting state tax liabilities found in 26 U. S. C. §§ 6361-6365 and that California could not take direct collection action against the Postal Service. The Supreme Court rejected this argument, stating that "nothing in that statute, which permits States to use the summary collection procedures of the Internal Revenue Service, limits the power of States to use any other available procedure." 467 U.S. 512, 525 n.22. *See also*, *Michigan Central Railroad Co. v. Powers*, 201 U.S. 245, 292-293 (1906) (with respect to state taxation, the state has the freedom of a sovereign, both as to objects and methods).

There is no federal statute or case law supporting Mr. Barnes' argument that only the Secretary of the Treasury or his delegate may determine and assess New Mexico personal income taxes. Nor does state law provide any authority for Mr. Barnes' position. In *Holt v. New Mexico Department of Taxation & Revenue*, 2002 NMSC 34, ¶ 9, 133 N.M. 11, 59 P.3d 491, the Mexico Supreme Court specifically held that "the State of New Mexico has the authority to assess and collect taxes without federal supervision." The *Holt* decision is binding on all state courts and administrative agencies and effectively disposes of Mr. Barnes' argument on this issue. *See Alexander v. Delgado*, 84 N.M. 717, 507 P.2d 778 (1973) (decisions of the New Mexico Supreme Court are binding on all lower courts).

Issue Three: Whether the information exchanged between the IRS and the Department is based upon fraud and errors. As the third ground for his protest, Mr. Barnes maintains that the information exchanged between the IRS and the Department "is based upon

fraud and errors." Petition of Protest at pages 10-15. Mr. Barnes argues that the Department should not rely on the RAR it received from the IRS because it "may be based upon erroneous information." Petition of Protest at page 15. If the figures the IRS provided to the Department concerning Mr. Barnes' 1999 income were incorrect, it was up to him to correct the error by producing his 1999 financial records for review. NMSA 1978, § 7-1-17(C) states that any assessment of taxes made by the Department is presumed to be correct, and the burden is on the taxpayer to overcome this presumption. *Holt v. New Mexico Department of Taxation & Revenue*, 2002 NMSC 34, ¶ 4, 133 N.M. 11, 59 P.3d 491. A taxpayer cannot shift the burden of proof to the Department merely by suggesting that the assessment is wrong. As stated by the New Mexico Court of Appeals in *Grogan v. New Mexico Taxation & Revenue Department*, 2003 NMCA 33, ¶ 12, (N.M. Ct. App., 2002):

> The Department's assessment is presumed to be correct. NMSA 1978, § 7-1-17(C) (1992); *Carlsberg*, 116 N.M. 247 at 249, 861 P.2d at 290. "The effect of the presumption of correctness is that the taxpayer has the burden of coming forward with some countervailing evidence tending to dispute the factual correctness of the assessment made by the secretary. *Unsubstantiated statements that the assessment is incorrect cannot overcome the presumption of correctness.*" 3.1.6.12(A) NMAC 2001. (Emphasis added).

In this case, Mr. Barnes has the most accurate and direct knowledge concerning the nature and source of his income during the tax year at issue. By failing to provide any evidence to show that the 1999 income figures the Department received from the IRS were incorrect, he failed to meet his burden of proof on this issue.

The rest of Mr. Barnes' arguments on Issue No. 3 are difficult to decipher. To the extent he is asserting that the IRS' release of his tax information violated the disclosure rules of 26 U.S.C. § 6103(d), his argument fails for two reasons.

First, federal courts have consistently held that the standard-form coordination and implementation agreements the IRS has entered into with each of the 50 states meet the disclosure requirements of § 6103(d). *Smith v. United States*, 964 F.2d 630 (7th Cir. 1992), *cert. denied*, 506 U.S. 1067 (1993); *Taylor v. United States*, 106 F.3d 833 (8th Cir. 1997); *Long v. United States*, 972 F.2d 1174 (10th Cir. 1992); *Stone v. Commissioner*, T.C. Memo 1998-314 (U.S. Tax Court Memos 1998); *McQueen v. United States*, 5 F.Supp.2d 473 (D. Tex. 1998). New Mexico entered into its Agreement on Coordination of Tax Administration with the Internal Revenue Service in 1988. In 1989 and again in 1999, the Department entered into an Implementation Agreement setting out the type of information to be exchanged between the IRS and Department, including examination reports with respect to individual income tax adjustments. Pursuant to settled case law, these agreements authorized the IRS' release of Mr. Barnes' 1999 tax information to the Department.

Second, even if the IRS did not follow proper procedures in releasing information to the Department, this is not the appropriate forum in which to raise that issue. Instead, Mr. Barnes' remedy is found in 26 U.S.C. § 7431, which creates a federal cause of action for the improper disclosure of an individual's return information. Suppression of such information is not one of the remedies provided in § 7431. As stated in *Nowicki v. Commissioner*, 262 F.3d 1162, 1163 (11th Cir. 2001):

> [I]mposition of the exclusionary rule is not warranted for a disclosure of return information which violates § 6103. Congress has specifically provided civil (I.R.C. § 7431) as well as criminal penalties (I.R.C. § 7213) for violations of § 6103. There is no statutory provision requiring exclusion of evidence obtained in violation of § 6103 and we will not invent one.

See also, United States v. Orlando, 281 F.3d 586, 595-596 (6th Cir. 2002). There is no legal authority to support the argument that improper disclosure under § 6103 warrants abatement of an otherwise valid state tax assessment.

IT IS THEREFORE ORDERED THAT the Department's Motion for Summary Judgment is granted, Mr. Barnes' protest of the personal income tax assessment issued under Letter ID L1666721792 is denied, and the administrative hearing currently scheduled for October 27, 2005 is vacated.

DATED October 17, 2005.

MARGARET B. ALCOCK
Hearing Officer
Taxation & Revenue Department
Post Office Box 630
Santa Fe, NM 87504-0630

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, § 7-1-25, the taxpayer has the right to appeal this Order Granting the Department's Motion for Summary Judgment by filing a notice of appeal with the New Mexico Court of Appeals within 30 days of the date shown above. *See*, NMRA, 12-601 of the Rules of Appellate Procedure. If an appeal is not filed within 30 days, the order will become final.

CERTIFICATE OF SERVICE

On October 17, 2005, a copy of the foregoing Order Granting the Department's Motion for Summary Judgment was mailed by both regular first class mail and certified mail # 7003 0500 0002 3966 6023 to Donald W. Barnes, Box 1224, Aztec, NM 87410, and delivered by interoffice mail to Jeffrey W. Loubet, Special Assistant Attorney General, Taxation and Revenue Department, Santa Fe, New Mexico.

MARGARET B. ALCOCK