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

IN THE MATTER OF THE PROTEST
OF DONALD AND LORI BREUER No. 99-22
ASSESSMENT NOs. 98047 & 98048

DECISION AND ORDER

A formal hearing on the above-referenced protest was held May 17, 1999, before Margaret B. Alcock, Hearing Officer. Donald A. Breuer appeared on behalf of himself and his wife, Lori Breuer. The Taxation and Revenue Department ("Department") was represented by Bruce J. Fort, Special Assistant Attorney General. The record was left open for one week following the hearing to allow Mr. Breuer to provide evidence of his income and the taxes withheld from his wages during tax years 1996 and 1997. This evidence was received on May 20, 1999, at which time the matter was submitted for decision. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Donald and Lori Breuer are residents of Bernalillo County, New Mexico.

2. Since 1994, Mr. Breuer has been employed by Intel Corporation in Rio Rancho, New Mexico, where he works as a technician.

3. In April 1996, the Breuers filed a 1995 New Mexico personal income tax ("PIT") return reporting federal adjusted gross income of $47,218.00, New Mexico taxable income of $30,606.00 and a net state tax liability of $1,204.00.

4. After filing his 1995 PIT return, Mr. Breuer's accountant told him he needed more tax credits or deductions to reduce his income tax liability.

5. Mr. Breuer began to research tax issues on the Internet and came across a website known as "Taxgate." Based on information on the website, Mr. Breuer came to the conclusion that his wages from Intel did not qualify as taxable income under the Internal Revenue Code.

6. Mr. Breuer asked his accountant to review the Taxgate information. She told Mr. Breuer the information appeared to be accurate but declined to advise Mr. Breuer as to whether he should act on the theories set out on the Taxgate website.

7. Mr. Breuer purchased a copy of the Internal Revenue Code and regulations to check the information on the website for himself and insure the accuracy of quotes taken from various sections of the Internal Revenue Code and related regulations.

8. In April 1997, the Breuers filed a 1996 New Mexico PIT return reporting federal adjusted gross income of zero, New Mexico taxable income of zero and a net state tax liability of zero. The return showed a refund due of the $833.34, which was the amount of state taxes Intel withheld from Mr. Breuer's wages during 1996.

9. The Department processed the Breuers' 1996 PIT return as filed and sent them a check for $833.34.

10. In April 1998, the Breuers filed a 1997 New Mexico PIT return reporting federal adjusted gross income of zero, New Mexico taxable income of zero and a net state tax liability of zero. The return showed a refund due of $1,079.00, which was the amount of state taxes Intel withheld from Mr. Breuer's wages during 1997.

11. On May 6, 1998, the Department sent the Breuers a letter denying their claim for refund. The letter questioned why a taxpayer whose employer had withheld $1,079.00 of state taxes from the taxpayer's income would have a federal adjusted gross income of zero and requested a copy of the Breuers' federal income tax return.

12. On May 8, 1998, Mr. Breuer sent the Department a copy of his 1997 federal income tax return, on which he had also reported wages of zero, and a statement that he was not required to report or pay federal income tax.

13. On December 4, 1998, the Department issued Assessment 98047 to the Breuers in the total amount of $2,486.37, representing $1,431.00 in personal income tax due for 1996, $715.50 penalty and $339.87 interest. The Department also issued Assessment 98048 in the total amount of $2,709.87, representing $1,707.00 in personal income tax due for 1997, $835.50 penalty and $149.37 interest.

14. The Department estimated the Breuers' 1996 and 1997 tax liability by using the federal adjusted gross income reported on their 1995 PIT return, increasing that amount by 10% and 20% respectively, and then subtracting the standard federal exemption and deduction amounts.

15. The Department did not give the Breuers credit for taxes withheld by Intel during 1996 because these taxes had been refunded to the taxpayers. The Department did not give the Breuers credit for taxes withheld by Intel during 1997 because the Department did not have a copy of the W-2 to verify the amount of the 1997 withholding.

16. On December 10, 1998, Mr. Breuer filed a written protest to Assessments 98047 and 98048.

17. At the hearing on Mr. Breuer's protest, the Department conceded the evidence was not sufficient to support assessment of the 50 percent fraud penalty for tax year 1997.

18. The Department also stated that if Mr. Breuer provided copies of this 1996 and 1997 W-2 forms, the Department would adjust the assessments to reflect the actual income and withholding shown on those forms.

19. The record was left open for one week, during which Mr. Breuer submitted copies of his W-2 forms for 1996 and 1997 and copies of mortgage interest statements showing mortgage

interest and real estate taxes paid during those years. Mr. Breuer also submitted a copy of an opinion letter he requested from a former Arizona assistant city magistrate concerning citizens' obligation to report and pay income taxes.

DISCUSSION

There are two issues to be determined in this protest: (1) whether the Breuers are liable for New Mexico income tax on Mr. Breuer's compensation from performing services in New Mexico during 1996 and 1997; and (2) if the answer to the first issue is yes, whether Mr. Breuer is liable for the 50 percent fraud penalty assessed against him for 1996. Before addressing the various arguments raised by Mr. Breuer, a brief overview of New Mexico's personal income tax statutes and their operation will be useful.

New Mexico imposes income tax on the net income of "every resident individual". New Mexico is among the majority of states that "piggy-back" or use the federal income tax system as the basis for calculating state income taxes. The calculation of personal income taxes in New Mexico begins with a determination of "base income" which is the taxpayer's "adjusted gross income" as defined in § 62 of the Internal Revenue Code, plus certain net operating loss deductions which can be deducted for federal purposes but which New Mexico does not allow to be deducted in the same manner. *See,* § 7-2-2(B) NMSA 1978. New Mexico then allows certain deductions, such as the federal standard or itemized deductions and deductions for income from federal obligations, to arrive at "net income" upon which income tax is imposed. *See*, §§ 7-2-2(N) and 7-2-3 NMSA 1978. Given the structure of the New Mexico income tax, most of Mr. Breuer's arguments—and this decision—are based on an examination of provisions of the Internal Revenue Code relating to determination of taxpayers' federal adjusted gross income.

I. COMPENSATION FOR SERVICES PERFORMED WITHIN THE UNITED STATES IS GROSS INCOME UNDER 26 U.S.C. § 61.

As noted above, New Mexico uses federal adjusted gross income as its starting point for calculating New Mexico personal income taxes. The Internal Revenue Code, 26 U.S.C. § 1, *et seq*. (1997), defines adjusted gross income as gross income, less certain deductions listed in § 62 of the Code. Gross income is defined in § 61 as follows:

> 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 endowments 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 under the first listed category of "compensation for services" the compensation Mr. Breuer received from performing services for his employer in New Mexico. Mr. Breuer nonetheless disputes the applicability of § 61 to the compensation he received from his work as a technician for Intel.

Mr. Breuer focuses first on the language in § 61 which refers to "items" of income. He maintains that an item of income is not the same as a source of income—in order for an item of income to be taxable, it must come from a taxable source. Mr. Breuer has determined that the only section of the Internal Revenue Code dealing with the taxation of income from sources within the United States is § 861 in Part I, Subchapter N of the Code. He has further concluded that only income from sources

under the "operative sections" of the Internal Revenue Code set out in the regulation at 26 CFR § 1.861-8(f)(1) is subject to federal income tax. Because Mr. Breuer's wages from Intel do not come within the purview of those sections of the Code, Mr. Breuer concludes that his wages are not subject to tax.

The problem with Mr. Breuer's analysis is that it relies on portions of federal statutes and regulations taken completely out-of-context and without regard to the overall statutory scheme of which they are a part. Mr. Breuer argues vehemently that the phrases he quotes from various sections of the law are not subject to interpretation. In support of this position, he relies on the rule of statutory construction that when the words of a statute are unambiguous, "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut National Bank v. Germain*, 503 U.S. 249, 253-254 (1992). It is also a rule of statutory construction, however, that statutes must be read in their entirety and each part must be construed in connection with every other part to produce a harmonious whole. *State ex rel. Klineline v. Blackhurst*, 106 N.M. 732, 735, 749 P.2d 1111, 1114 (1988). *See also*, *United States v. Morton*, 467 U.S. 822, 828 (1984) ("we do not construe statutory phrases in isolation; we read statutes as a whole"); *Crandon v. United States*, 494 U.S. 152, 158 (1990) ("in determining the meaning of the statute, we look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy"). In *McCarthy v. Bronson*, 500 U.S. 136, 139 (1991), a unanimous Supreme Court rejected what it acknowledged was a "reasonable" construction of words in a federal statute dealing with prisoner complaints because that construction was not in accord with the intent of the statute as a whole:

> We do not quarrel with petitioner's claim that the most natural reading of the phrase "challenging conditions of confinement," when viewed in isolation, would not include suits seeking relief from isolated episodes of unconstitutional conduct. *However, statutory language must always be read in its proper context.* "In ascertaining the plain meaning of [a] statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole." *K Mart Corp. v. Cartier, Inc.,* 486 U.S. 281, 291, 108 S.Ct.1811, 1817, 100 L.Ed.2d 313 (1988). (emphasis added)

A similar analysis was applied in the earlier case of *Alexander v. Cosden Pipe Line Co*., 290 U.S. 484, 496 (1934), in which the Supreme Court reversed a lower court decision construing two statutes taxing the transportation of oil.

> We cannot assent to the construction which the courts below placed on these statutes. It must be conceded that the statutes are not happily phrased and that some of their provisions separately considered give color to that construction. *But the statutes are to be considered, each in its entirety and not as if each of its provisions was independent and unaffected by the others*. (emphasis added)

In this case, Mr. Breuer's construction of isolated portions of the Internal Revenue Code and related regulations may appear reasonable when taken at face value and without considering other provisions of the Code. When placed in proper context, however, it is clear this construction does not reflect the true meaning of the statutes and is directly contrary to the overall income tax scheme enacted by Congress.

Section 61 of the Code defines "gross income" as "all income from whatever source derived." The same language is found in the Sixteenth Amendment of the federal Constitution which gives Congress the "power to lay and collect taxes on income, from whatever source derived...." The Sixteenth Amendment was proposed and ratified in order to eliminate the distinction between taxes on income from property, which had to be apportioned, and taxes on income from labor, which could be taxed without apportionment. As the Supreme Court noted in *Brushaber v. Union Pacific Railroad Co*., 240 U.S. 1 (1916): "the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived." Far from requiring income to be traced to a specific source in order to determine whether it can be taxed, the Sixteenth Amendment made the source of income irrelevant for all but a very few taxpayers. As stated in Treasury Regulation § 1.1-1(b): "In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable for the income taxes imposed by the Code whether the income is received from sources within or without the United States." The source of income is

relevant only to nonresident aliens and foreign corporations, whose tax liability is limited to income from sources within the United States. Congress enacted Subchapter N of the Internal Revenue Code, titled "Tax Based on Income From Sources Within or Without the United States," in order to identify the income on which this group of taxpayers must pay tax.

Sections 861 through 865 in Part I of Subchapter N of the Code address "Source Rules and Other General Rules Relating to Foreign Income." Although Mr. Breuer maintains his tax liability is limited to income from sources identified in § 861 and accompanying regulations, there is no indication that Mr. Breuer has foreign income or that Subchapter N has any application to him. I note, nonetheless, that § 861(a)(3) and regulation § 1.861-4 provide that compensation for labor or personal services performed in the United States is treated as income from sources within the United States. There is no rationale for Mr. Breuer's argument that the compensation he earned for personal services performed in New Mexico was not income because it did not come from a "source" set out in regulation § 1.861-8(f)(1). That regulation does not identify sources of income but simply lists other sections of the Code to which the principles of Section 861 apply.

When placed in context, it is clear that § 861 and the regulations promulgated under that section apply to a determination of the tax liability of nonresident aliens and foreign corporations. These provisions have no application to United States citizens like Mr. Breuer, all of whose income is derived from wages for services performed within the United States. The federal courts have held, on numerous occasions, that such wages come within the definition of income under the Internal Revenue Code and are subject to taxation. *See, e.g., Funk v. Commissioner*, 687 F.2d 264, 265 (8th Cir. 1982); *Grimes v. Commissioner*, 806 F.2d 1451, 1453 (9th Cir. 1986). In *United States v. Buras*, 633 F.2d 1356, 1361 (9th Cir. 1980), the court specifically rejected the argument that wages are not income because they are not derived from a taxable source:

> According to Buras, income must be derived from some source. Wages cannot be taxed because the wage earner enjoys no gain from that source....
>
> ...
>
> As for Buras' argument that he may not be taxed because he is a wage earner, the Sixteenth Amendment is broad enough to grant Congress the power to collect an income tax regardless of the source of the taxpayer's income.

In *United States v. Koliboski*, 732 F.2d 1328, 1329 n.1 (7th Cir. 1984), upholding Mr. Koliboski's criminal convictions for failure to file federal income tax returns and filing false withholding statements, the court addressed the argument that wages are not income as follows:

> [T]he defendant still insists that no case holds that wages are income. Let us now put that to rest: WAGES ARE INCOME. Any reading of tax cases by would-be tax protesters now should preclude a claim of good-faith belief that wages—or salaries—are not taxable. (emphasis in the original).

Mr. Breuer's compensation from performing services for his employer in New Mexico qualifies as gross income under § 61 of the Code and is subject to both federal and New Mexico income tax.

II THE DEFINITION OF "EMPLOYEE" INCLUDES PRIVATE WAGE EARNERS.

Mr. Breuer next argues that only government officials and corporate officers are "employees" subject to federal income tax. This argument is based on a misreading of § 3401 of the Internal Revenue Code, which relates to the obligation of employers to withhold income tax from the wages of their employees. Subparagraph (c) defines the term "employee" as follows:

> For purposes of this chapter, the term "employee" includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

Mr. Breuer interprets the word "includes" as a word of limitation. He asserts that only those persons listed in the statute come within the definition of employees subject to withholding. Because he is not a government official or corporate officer, Mr. Breuer concludes that his employer is not required to

withhold tax from his wages and he is not required to report tax on his wages to the government. This interpretation of § 3401(c) is incorrect and has been soundly rejected by the federal courts. As the court stated in *United States v. Latham*, 754 F.2d 747, 750 (7th Cir. 1985):

> Latham's instruction which indicated that under 26 U.S.C. § 3401(c) the category of "employee" does not include privately employed wage earners is a preposterous reading of the statute. It is obvious...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.

See also, Sullivan v. United States, 788 F.2d 813, 815 (1st Cir. 1986): "Section 3401(c)...indicates that the definition of 'employee' *includes* government officers and employees, elected officials, and corporate officers. The statute does not purport to limit withholding to the persons listed therein." (emphasis in the original).

The term "employee" as defined in § 3401(c) includes private wage earners like Mr. Breuer, as well as government officials and corporate officers.

III FORM 1040 HAS BEEN ASSIGNED AN OMB NUMBER IN COMPLIANCE WITH THE PAPERWORK REDUCTION ACT OF 1980.

Mr. Breuer maintains he is not required to file a federal income tax return because Form 1040 is not listed by the Office of Management and Budget as a form required to be filed under Treasury Regulation § 1.1-1. Again, Mr. Breuer has interpreted the law by focusing on one small section of a statute or regulation and blocking out the intent and meaning of the law as a whole.

Under the Paperwork Reduction Act of 1980 (44 U.S.C. §§ 3501-3520) and related regulations, the Office of Management and Budget (OMB) must assign a number to each form required by an agency of the federal government for the collection of information and identify the regulation that requires the form to be filed. The individual income tax return, Form 1040, was assigned OMB control number 1545-0074, and is listed as a form required by a number of different Treasury regulations, including regulations under Code sections 6011 ("General Requirement of Return, Statement or List"),

6012 (Persons Required to Make Returns of Income"), and 6013 ("Joint Returns of Income Tax by Husband and Wife"). *See*, listing at 26 CFR § 601.9000. The 1997 Form 1040 Mr. Breuer filed with the IRS, a copy of which is attached to Mr. Breuer's May 8, 1998 letter to the Department, clearly displays OMB No. 1545-0074 in the upper right-hand corner.

Mr. Breuer's contention that Form 1040 also must be listed as a form required under Treasury Regulation § 1.1-1 is without merit. Section 1.1-1 imposes a tax on taxable income and provides the rates for calculating the tax. This regulation does not actually require the collection of any information—the requirement for filing income tax returns is found in §§ 6011 through 6014 of the Code and the regulations under those sections. The listing of Form 1040 as a form required to be filed under these regulations fully complies with the Paperwork Reduction Act of 1980.

IV IMPOSITION OF THE FRAUD PENALTY IS NOT JUSTIFIED IN THIS CASE.

The Department's assessments of income tax to Mr. and Mrs. Breuer included the 50 percent civil penalty authorized by Section 7-1-69(C) NMSA 1978 when a taxpayer's actions are based on a willful intent to evade or defeat any tax. Although Section 7-1-17(C) NMSA 1978 creates a statutory presumption that any assessment of tax by the Department is correct, the presumption does not apply to fraud assessments. As stated in Section 7-1-78 NMSA 1978:

> BURDEN OF PROOF IN FRAUD CASES. In any proceeding involving the issue of whether any person has been guilty of fraud or corruption, the burden of proof in respect of such issue shall be upon the director or the state.

At the hearing on Mr. Breuer's protest, Department counsel conceded there was insufficient evidence to support the penalty imposed by Assessment No. 98048 for tax year 1997. Based on the evidence presented, the Department also failed to meet its burden to establish the Breuers' liability for the penalty imposed by Assessment No. 98047 for tax year 1996. Although Mr. Breuer's arguments had no legal merit, I was not convinced that he did not, himself, believe them to be reasonable

arguments. Mr. Breuer testified that he conducted extensive research on the Internet and provided copies of some of the material he came across on the Taxgate website. He asked an accountant to review this information. Although she declined to advise him as to what course of action to follow, she did tell him that the information on the website appeared to be accurate. Mr. Breuer then purchased a copy of the Internal Revenue Code and regulations to check the information on the website for himself and insure the accuracy of quotes taken from various Code sections.

Although the 50 percent penalty is not justified for the current assessments, Mr. Breuer now has reason to know the Taxgate arguments on which he relied do not have merit. Unless this decision is appealed and overturned, he cannot continue to assert that he has no taxable income or that his income is exempt without risking the imposition of a fraud penalty. As the court stated in *Coleman v. Commissioner of Internal Revenue*, 791 F.2d 68, 69 (7th Cir. 1986):

> Some people believe with great fervor preposterous things that just happen to coincide with their self-interest. "Tax protesters" have convinced themselves that wages are not income, that only gold is money, that the Sixteenth Amendment is unconstitutional, and so on. These beliefs all lead—so tax protesters think—to the elimination of their obligation to pay taxes. The government may not prohibit the holding of these beliefs, *but it may penalize people who act on them.* (emphasis added).

In this case, there is no question that Mr. Breuer's compensation from his employment in New Mexico is income for federal and state tax purposes, and the Breuers have an affirmative duty to report and pay tax on this income to both the federal government and the state of New Mexico.

V THE ASSESSMENTS SHOULD BE ADJUSTED TO REFLECT THE INCOME AND WITHHOLDING INFORMATION ON MR. BREUER'S W-2 FORMS.

The assessments at issue were based on the Department's estimate of the Breuers' 1996 and 1997 income. The Department used the federal adjusted gross income reported on the Breuers' 1995 PIT return, increased that amount by 10% and 20% respectively, and then subtracted the standard federal exemption and deduction amounts. At the hearing on Mr. Breuer's protest, Department

counsel stated that if Mr. Breuer provided copies of his 1996 and 1997 W-2 forms, the Department would adjust the assessments to reflect the actual income and withholding reflected on those forms (except for the 1996 withholding amount previously refunded to the Breuers).

Mr. Breuer subsequently submitted copies of his W-2 forms for 1996 and 1997, as well as copies of mortgage interest statements showing mortgage interest and real estate taxes paid during those years. Based on the documentation submitted, Assessment No. 98047 for tax year 1996 should be adjusted to reflect tax on income of $49,314.83; Assessment No. 98048 for tax year 1997 should be adjusted to reflect tax on income of $53,251.14, with a credit for withholding of $1,078.51.

The Breuers are not entitled to claim itemized deductions for mortgage interest and real estate taxes in lieu of the standard federal deduction. The deduction allowed in determining New Mexico taxable income is based on the deduction taken on the taxpayer's federal income tax return, and taxpayers who wish to claim the benefit of itemized deductions must complete Schedule A to their Form 1040. In this case, there is no evidence the Breuers itemized their deductions on their 1996 and 1997 federal income tax returns. To the contrary, the 1997 federal income tax return introduced at the hearing shows they claimed the standard deduction for that year. Their deduction for New Mexico income tax purposes is limited to the amount shown on their federal return. If the Breuers wish to take advantage of itemized deductions for 1998 and future years, they must first file a properly completed federal income tax return listing those deductions on Schedule A to Form 1040.

CONCLUSIONS OF LAW

1. Mr. Breuer filed a timely, written protest to Assessment Nos. 98047 and 98048 pursuant to § 7-1-24 NMSA 1978, and jurisdiction lies over both the parties and the subject matter of this protest.

2. Mr. Breuer's compensation from performing services in New Mexico is included in both "gross income" and "adjusted gross income" as those terms are defined in the Internal Revenue Code.

3. Mr. Breuer's compensation is included in both "base income" and "net income" as those terms are defined in the Income Tax Act, Chapter 7, Article 2, NMSA 1978.

4. The Breuers are liable for payment of New Mexico income tax, plus accrued interest, on the compensation Mr. Breuer received from Intel during 1996 and 1997, less the standard federal deduction and exemption amounts. The Breuers are also entitled to a credit of $1,078.51 for tax withheld by Intel during tax year 1997.

5. The Breuers are not liable for payment of the 50 percent civil penalty assessed by the Department.

For the foregoing reasons, the Breuers' protest is GRANTED IN PART AND DENIED IN PART. THE DEPARTMENT IS ORDERED TO ADJUST ASSESSMENTS 98047 AND 98048 IN A MANNER CONSISTENT WITH THIS DECISION.

Dated May 28, 1999.