

# **Income Taxes and the Destruction of Liberty**

**By Vernon K. Jacobs, CPA**

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## **Income Taxes and the Destruction of Liberty**

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# Income Taxes & The Destruction of Liberty

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## Introduction

The Justices of the U.S. Supreme Court are regarded as the most brilliant and revered legal minds in the U.S. and the experts on the Constitution. Yet, the majority of them since the early 1900s have concluded that few of the provisions of the Constitution and the Bill of Rights apply to the imposition and the administration of taxes by the Federal government. Attempts to dispute the validity of the income tax or its varied statutes and regulations are generally dismissed by the Supreme Court as being frivolous and without merit.

But Charles Adams, author of *For Good and Evil: The Impact of Taxes on The Course of Civilization*, argues that “The concept of checks and balances in government had its origin, most of all, in checks on the tax gatherers. .. Without strict and clear constitutional standards for tax making, ratification (of the Constitution) wouldn’t have had a prayer.”

The framers of the Constitution believed that criminal law applied to disputes between the citizens and the government whereas civil law applied to disputes between citizens. But the highest court has upheld the argument that criminal law only applies when the government is accusing a citizen of a crime for which incarceration is a penalty, whereas the imposition of penalties for non-compliance with government statutes is only a matter of civil law and is not subject to the safeguards of the Constitution.

The 8<sup>th</sup> Amendment states that “Excessive ... fines (shall not be) imposed, nor cruel and unusual punishments inflicted.” Somewhat obviously, the term “excessive” is subject to individual interpretation, but the U.S. tax law does impose many fines that sane people would regard as “excessive” and which are not subject to the safeguards of the Constitution.

The framers of the Constitution believed that any kind of taxes must be uniform and should not be imposed directly on the taxpayer. Article 1, Section 9 of the Constitution requires uniformity (and apportionment) for any form of direct tax. Uniformity meant that a tax must be equal in amount or an equal percentage of some transaction. But this provision was over-ruled by the 16<sup>th</sup> Amendment.

The 5<sup>th</sup> Amendment to the Constitution states in part that “ ... nor shall private property be taken for public use without just compensation.” This clause clearly did not anticipate that an income tax might be enacted

The 4<sup>th</sup> Amendment provision against unreasonable search and seizure had its roots in the manner that the King’s tax collectors would force their way into homes and businesses. Although the IRS is required to secure court approval to demand records from a taxpayer, the process is not transparent, does not require

the government to show probable cause and does not give the taxpayer a right to be informed in advance as to the purpose of the examination.

The Tenth Amendment to the Constitution states “The Powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the states respectively, or to the people.” The income tax has indirectly violated this rule.

## **Income Taxes and the Erosion of Liberty**

Prior to the 16<sup>th</sup> Amendment, the U.S. Constitution prohibited discriminatory taxes. With ratification of the 16<sup>th</sup> Amendment in 1913, a veritable “Pandora’s Box” was opened to permit the government to impose taxes of any form on any segment of the populace.

Until about 1945, the public accepted their tax burden as being due to the needs of a wartime economy or to the hoped for recovery from a terrible depression. After the Second World War, Americans mostly accepted the need to maintain a military that could protect them from the expansionist policies of the Soviet Union and the threat of nuclear war.

At the end of the Second World War, the top income tax rate was 90%, but it was soon reduced to 70%. Rather than reduce the tax rates further, the government began to introduce an assortment of tax exemptions, exclusions and deductions that made the tax far more palatable to different groups of taxpayers. In the early 1960s, the government began to use the income tax to confer benefits on selective groups of taxpayers. These discriminatory rules were justified as making the law more fair – but in fact many of the tax preferences were granted for the benefit of political supporters.

One of the most familiar passages in The Declaration of Independence states that “We hold these truths to be self-evident, that all men are created equal”

This belief has been regarded as the basis for the principle that taxes should be imposed on an equal basis – regardless of the degree of wealth of any citizen. Thus, the Constitution directed that “direct taxes shall be apportioned among the several States”, which essentially meant that they must be equal. Because of the 16<sup>th</sup> Amendment, the income tax permits the government to impose taxes that are not uniform in amount nor even in percentage terms.

## Article 1.7 of the Constitution and the 16<sup>th</sup> Amendment

Article 1, Section 7 of the Constitution provides (in part) that "...**direct** taxes shall be apportioned among the several States." (Emphasis added.)

In 1796, the Supreme Court held that a direct tax was a tax on land or a head tax, but in 1894, the Supreme Court concluded that it also included an income tax and was therefore prohibited. And - it is not feasible to apportion an income tax equally among the population. In order to impose an income tax, it was first necessary to over-rule the Constitutional prohibition against a direct tax.

The 16<sup>th</sup> Amendment states rather simply,

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

The current income tax was the third income tax and was imposed in 1913. The first was the temporary income tax in the Northern States during the Civil War, which was repealed after the war. The second was the income tax imposed in 1894 and overturned by the Supreme Court a year later. After ratification of the 16<sup>th</sup> Amendment, the initial form of our current income tax was enacted in 1913.

Historians don't all agree on the social and political motives for enacting an income tax, but most agree that it was fostered by pressure from Populists, Socialists, Communists and land owners in the Southern and Western states based on wanting to tax those "wealthy" industrialists (often called robber barons) in the Northeast. The income tax in 1917 provided for tax rates of from 1% to 7%.

The law was quickly contested and was held to be valid by the Supreme Court. Since then there have been hundreds of diverse legal arguments about why some part of the income tax is unconstitutional, but the courts have consistently upheld the power of the Congress to impose income taxes and to vary the tax among the taxpayers.

Essentially, the income tax is not what the framers of the Constitution intended, but it is now a part of the Constitution by virtue of the 16<sup>th</sup> Amendment.

## Unreasonable Searches and Seizures

The 4<sup>th</sup> Amendment to the Constitution provides in part that "The right of the people to be secure in their persons, papers and effects against unreasonable searches and seizures shall not be violated. ..."

But the income tax law permits the IRS to impose audits on taxpayers in their homes or offices. Even if a taxpayer agrees to bring the requested papers to the office of a tax lawyer or accountant (or to the office of the IRS agent), the IRS can freely demand a wide range of documents merely by contending they are pertinent to an examination of the tax return. The IRS is currently auditing a taxpayer who is in the business of forming legal entities such as corporations or LLCs and they have been demanding to see a list of all of his customers. If he complies, he would soon be out of business. So they have been demanding to see numerous other documents to wear him down. This has been going on for about two years. Although the IRS is not permitted to break into a home or office to search for incriminating papers, they do have the power to demand that taxpayers provide virtually any kind of documents in support of any part of a tax return. And it is not necessary for them to show probable cause in order to secure those papers.

And once a tax is deemed to be past due and is turned over to the collection division, the collectors can attach bank accounts and other financial assets, they can shut down a business and auction off the assets and they can seize any other asset of the taxpayer.

## **Confiscation Without Compensation**

The 5<sup>th</sup> Amendment to the Constitution states in part that “... nor shall private property be taken for public use without just compensation.” This clause clearly did not anticipate that an income tax might be enacted that would permit the taking of property derived from various forms of income, as distinguished from the taking of tangible property without compensation. When the 16<sup>th</sup> Amendment became part of the Constitution, in 1913, the absolute right of property in the United States was effectively repealed.

## **Cruel and Unusual Punishment**

The 8<sup>th</sup> Amendment states that “Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” Somewhat obviously, the term “excessive” is subject to individual interpretation, but the U.S. tax law does impose some fines that sane people would regard as “excessive” or even obscene. Here are a very few examples.

The 2007 *Small Business & Work Opportunity Act* included a provision that imposes a penalty of the greater of \$5,000 or up to 50% of the fees derived by a tax preparer for “Willful or reckless conduct” in the preparation of a return. Because of a combination of federal and state income taxes and the self-employment tax, most moderately successful tax preparers pay a tax of 40% to 50% of their net earnings. Thus, the government collects close to 100% of the

fees from a return even if the alleged misconduct involves only a small part of the total return. To contest the penalty, the tax preparer must be able and willing to spend the money and time to dispute the penalty in court.

A U.S. citizen living in London for many years established a trust for his wife. The trustee hired a London investment manager who used the trust assets to trade shares of various foreign mutual funds. The taxpayer died and his wife moved to the U.S., leaving the trust arrangement as is for many years. She became ill and her son stepped in to oversee her financial affairs. The son discovered that the foreign mutual funds are subject to different rules than domestic funds. Basically, the deferred gains are subject to tax at the highest tax rate in the tax tables and the losses are not deductible. The deferred gains are allocated back to the date the funds were first acquired and interest is imposed on the tax as far back as 1987. In many cases such as this, it's possible for the tax to exceed the gains from the investments.

A taxpayer wanted to invest in some foreign securities that are not listed on a U.S. stock exchange. Because of SEC rules, the foreign bank required the investor to establish a corporation through which to buy and own the foreign securities. The taxpayer did not seek guidance and failed to file information returns for the foreign corporation. He is subject to a potential \$20,000 penalty each year for up to six years for failing to file two different tax forms for a corporation with a negative income.

A taxpayer with a foreign trust is required to file a trust information return by March 15<sup>th</sup> or to submit a request for an extension. I filed the return for a taxpayer (who was traveling) on March 14<sup>th</sup>. The IRS imposed a 35% penalty on a \$ 2 million trust because the return was received 6 days after March 15<sup>th</sup>. We were only able get them to rescind the penalty because I had absolute proof that the return had been mailed on the 14<sup>th</sup>.

If a taxpayer is accused of willfully failing to file a foreign bank account disclosure form, the penalty is beyond "excessive". It is absolutely obscene. For individuals, the penalty is \$250,000 and five years in prison. And if the government is not able to prove that the failure to file this form was willful, the IRS can still impose a penalty of up to \$10,000 per year for a non-willful failure to disclose the existence of certain foreign financial accounts. A senior official of the IRS is telling his staff that they should seek the penalty for up to six years. Therefore if someone has a foreign mutual fund or savings account with a value of just over \$10,000 and has had the account since 2002, the IRS can impose a penalty of \$60,000 for a failure to report that account in each year since 2002.

## **Powers to Be Reserved to the States**

The Tenth Amendment to the Constitution states “The Powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the states respectively, or to the people.”

The imposition of a national income tax and its attendant provisions for enforcement had the effect of bypassing the states in the collection of taxes and put the Federal government in direct contact with the citizens of the various states.

According to Frank Chodorov, author of “The Income Tax: Root of All Evil”,

“The state governments ... lost more and more of their autonomy. Not only was their source of revenue being dried up by federal preemption, so that they had less and less for the social services a government should provide, but they were compelled in their extremity to apply to the central authorities for help. In so doing they necessarily gave up some of their independence (and became dependent on the Federal Government).”<sup>1</sup>

## **Discriminatory (Non Uniform) Taxation**

Although it is a major premise of the Constitution that all persons should be treated as being equal under the law, the income tax has become the most extreme example of legislative discrimination between different classes of citizens. In the nearly 100 years since its passage, the U.S. income tax has become the most blatantly discriminatory form of taxation in known history. Here are a few examples.

### **=> Unmarried versus Married**

The disparity between the tax rates, exemptions and deductions for single taxpayers and married couples filing jointly has been a long and persistent tax problem. Currently, two single taxpayers pay less tax than a married couple with the same combined income. The tax brackets are equalized up to the 15% bracket after which the single taxpayers don't move up the brackets as quickly as a married couple. Two single taxpayers with any dependents have lower rates and larger deductions than a married couple with the same number of dependents. Two single taxpayers can make larger deductible contributions to retirement plans and IRAs and they have a larger total exemption from the alternative minimum tax. They also get twice the deduction for business

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<sup>1</sup> Frank Chodorov, The Root of All Evil, the Mises Institute, <http://mises.org/etexts/rootofevil.asp>

equipment, and they have to pay less income taxes on Social Security benefits as a married couple with the same benefits.

### **=> The Young vs. Seniors**

Taxpayers over the age of 65 enjoy an assortment of tax breaks that are not available to younger taxpayers. One is the elimination of the 10% penalty on distributions from qualified retirement plans or annuities after age 57.5. Larger deductions for long-term care insurance are available for older taxpayers. Taxpayers over age 65 get larger standard deductions. Older taxpayers also get to make “catch-up” contributions to various retirement plans and health savings accounts in excess of what can be deducted by younger taxpayers.

### **=> Renters versus Home Owners**

It's not an exaggeration to call home ownership the “Great American Tax Shelter.” Gain on the sale of a residence can be tax free up to \$250,000 and twice that for a married couple. Interest on loans of up to \$1 million is deductible for loans on a residence and property taxes are deductible. With a very limited amount of equity homeowners can deduct nearly all of their monthly payments. The rental value of a paid off home is like tax-free income. Those who rent don't get any of these tax breaks.

### **=> “Rich” versus the “Poor”**

An entire book could be devoted to the topic of how those with a higher income or substantial assets pay more income taxes and estate taxes. According to the National Taxpayer's Union, the top 50% of the taxpayers (in terms of adjusted gross income) paid 97% of the personal federal income tax in 1995. The top 5% paid about 60% of the total personal income tax. Federal estate taxes are currently exempt for estates of up to \$2 million. Above that amount, 45% of the excess estate is taken for taxes. When income is taxed at rates of up to 35% plus another 10% for some state income taxes, it only leaves 55% of the excess for your heirs. But up to 45% of that could go to pay estate taxes (after the available exemption), leaving only 30% for the heirs.

### **=> Employees versus the Self Employed**

Employees enjoy a variety of tax-free benefits that can be provided by their employer – if the employer is so inclined. Some of these benefits are not available to those who are self employed. On the other hand, the self-employed enjoy many tax breaks not available to those who are employees. To the extent that a car or home is used partly for business, a part of the cost is deductible. Travel related expenses for business are deductible by the self-employed but are treated as miscellaneous itemized deductions for employees and are substantially reduced by higher income employees. A self-employed person may

be able to operate a business in the form of a corporation that can accumulate assets and net worth without being subject to Social Security taxes.

### **=> Earned income versus Passive Income**

Earned income is subject to Social Security taxes of up to 15.3% of the earnings. An employer might pay half of that and the balance would be paid by the employee. The self-employed pay the full amount. But investors who own a share of a business that is not incorporated are subject to a variety of limitations that are not applicable to those who operate the business day to day. Losses, depreciation deductions and various tax credits are either not allowed or are limited for what are called passive investors.

### **=> Capital Gains and Dividends vs. Other Income**

Some investment income like interest on state and municipal bonds is tax-free. Long term capital gains and certain kinds of dividend income are eligible for a maximum tax rate of 15%. Other types of investment income and earned income are subject to tax rates of up to 35%.

### **=> Tax Haven U.S.A.**

The U.S. is a tax haven for non-resident aliens. That's one of the reasons why so much of our federal debt is purchased by foreign persons. They don't have to pay U.S. taxes on interest on federal or state bonds, obligations of U.S. banks, S&Ls or insurance companies. Gains on owning U.S. securities are tax free. These exemptions are not available for U.S. investors.

### **=> U.S. Mutual Funds versus Foreign Mutual Funds**

Investors in most U.S. mutual funds are required to pay income taxes on their share of the profits of the mutual fund. Capital gains and dividends are taxed at a low rate ranging from 5% to 15%. U.S. investors in foreign mutual funds have three choices. They can elect to treat the fund as a pass-through entity, but the fund has to provide the investor with a lot of detail – which most foreign funds won't do. The second choice is to treat an increase in the market value of the fund as ordinary income each year. But the fund has to be listed on a major stock exchange. U.S. owners of foreign funds that don't satisfy either of these options are subject to some obscenely complex and costly taxation. In some cases, the tax and interest can exceed the income from the foreign mutual fund.

### **=> Non Filing of U.S. Tax Returns versus Foreign Returns**

If you don't file a U.S. Income tax return, the penalty is usually based on the amount of tax that you owe. If your income is less than the statutory exemptions and deductions and you don't owe any tax, there isn't a penalty for non-filing. But

if you have a foreign trust and don't file the required information returns on a timely basis, the penalty is 35% of the assets in the trust – even if the trust has no taxable income. And if you own shares in a foreign corporation or partnership controlled by U.S. persons and you fail to file an information return, the penalty is \$10,000 – even if the business had no profits.

## The Sources of U.S. Tax Law

As indicated earlier, the authority for the imposition of an income tax is derived from the 16<sup>th</sup> Amendment to the Constitution and the fact that the Supreme Court has upheld the validity of the income tax against numerous challenges.

### => The Internal Revenue Code

Title 26 of the U.S. Code of Regulations is referred to as the Internal Revenue Code or IRC. The Internal Revenue Code is the portion of the U.S. Code that consolidates all of the statutes and changes to any statutes that involve the administration of the tax laws, including the income tax, Social Security and Medicare and other employment taxes, the estate and gift taxes and many kinds of duties and excise taxes.

According to [The U.S. Tax Code On Line](http://www.fourmilab.ch/uscode/26usc/),<sup>2</sup> “The complete Internal Revenue Code contains more than 3.4 million words; printed 60 lines to the page, it would fill more than 7,500 letter-size pages.” To conserve space, the tax code uses extensive cross-referencing to other parts of the tax code as a substitute for explaining the cross reference in any semblance of English. This forces readers to look up numerous other parts of the tax code in order to understand the scope of any section with cross-references.

In spite of this mountain of verbiage, every citizen is presumed to be familiar with the U.S. Tax Code. While ignorance of the law is an excuse from criminal sanctions in the tax law, it is not an excuse for the imposition of numerous burdensome penalties.

### => Tax Treaties

Tax treaties are negotiated agreements between countries that have the same type of tax (such as an income tax) for the primary purpose of avoiding double taxation and determining which country shall impose a tax in various situations. Under the Supremacy clause of the Constitution, both treaties and federal legislation are the supreme law of the land.

The terms of tax treaties generally override the Internal Revenue Code when there is a conflict. Tax code section 894(a)(1) provides that “The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer”.

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<sup>2</sup> <http://www.fourmilab.ch/uscode/26usc/>

Only a handful of tax professionals are even remotely familiar with the terms of different tax treaties, but the law presumes that taxpayers are aware of any treaty provisions that over-rule any provisions of the Internal Revenue Code.

### **=> IRS Regulations**

The Internal Revenue Service Issues two general types of regulations. One is for the purpose of providing guidance and an explanation of various parts of the Internal Revenue Code. The second type of regulation is delegated to the IRS by a specific tax statute to implement the intent of a particular tax provision. The first type of regulation is simply the interpretation of the IRS and is given substantial weight by the courts but is not accepted as having the force of law. The second type is treated as having the force of law so long as the regulation is not deemed to be inconsistent with the enabling law.

Commerce Clearing House is one of the largest tax publishers in the U.S. and is reputed to be the primary supplier of tax law publications for the IRS. Their printed copy of the Internal Revenue Code is in two thick volumes, the bulk of which is printed in ten point type. By contrast, their printed copy of the IRS regulations consumes six volumes, the bulk of which is in eight-point type on very thin paper. Taxpayers and tax professionals are also presumed to be aware of the IRS regulations.

### **=> Revenue Rulings**

From time to time, the IRS issues an interpretive ruling with respect to a specific type of transaction. An example might be a ruling describing the circumstances under which a particular type of expense would be deductible. These rulings are often issued to give guidance to taxpayers in advance of a regulation and can be relied on by taxpayers.

Another type of ruling is a “private letter ruling”, which is issued only for the benefit of a specific taxpayer in contemplation of a specific set of facts. Other taxpayers can’t rely on these rulings but they are published because of the Freedom of Information Act. However, where there are a number of such rulings involving similar facts, taxpayers often rely on them as an indication of how the IRS would most likely treat a similar transaction.

### **=> The Court System**

Disputes between taxpayers and the IRS as to the meaning or intent of various provisions of the Internal Revenue Code are resolved in a variety of federal courts. Because of the numerous cases involving tax matters and the complexities of the tax law, the U.S. Tax Court was created to deal with only tax matters. A special benefit of using the tax court is that a tax and/or penalty does not have to be paid until the issue is resolved. If a dispute is taken to the circuit

courts or district courts, the tax, interest and penalties must be paid in advance and the taxpayer is basically suing for a refund.

If a tax advisor tells a taxpayer that a particular transaction is legal, the law presumes that the advisor has considered the implications of any court cases that have any bearing on the issue.

### **=> Authoritative Support**

When a taxpayer is trying to determine if a particular transaction is legal or to determine what the law requires with respect to a particular transaction, the only sources of “authoritative support” are the tax code, applicable treaties, the IRS regulations, applicable court decisions, applicable revenue rulings and a few other types of IRS memos.

There are a variety of other types of rulings or communications by the IRS that may or may not be a source on which a taxpayer may rely.

The most common type of information with which most taxpayers have had some exposure is the instructions to specific forms. Another category involves a variety of tax information publications about different types of subjects such as medical expense deductions, deductions for losses, the tax rules for foreign persons with U.S. source income and on and on. Although these publications generally represent the attitude of the IRS relative to a specific issue, they can't be relied upon as an authoritative source of law.

### **=> Criminal Tax Evasion and Civil Tax Avoidance**

The tax law includes a distinction between tax avoidance and tax evasion. Disputes about the meaning of the law and attempts to avoid or reduce a tax generally are treated as civil disputes. The consequences are limited to the imposition of interest and penalties if the IRS prevails. Certain types of willful attempts to evade a tax may be subject to incarceration for those who lose the criminal cases. Jury trials can be obtained for criminal cases but not for civil cases. Generally, the main distinction in a criminal case is that the taxpayer is alleged to have known what the law required and willfully failed to comply. Willfulness is often determined by a showing of an attempt to hide or to disguise what was done.

One of the most insidious rules that can lead to a criminal conviction of a taxpayer is that the taxpayer is required to unilaterally bind himself under penalty of perjury when signing any tax document. If the taxpayer refuses to sign the document, the law treats the information as if it has not been provided. The statute of limitations does not begin and penalties and interest for a non-filed return may be imposed by the IRS.

## The Economic Means and the Political Means

There are those who labor to produce the goods and services to satisfy their basic needs for water, food, shelter and protection from the adversities of life. They either produce what they need or they exchange something they have in excess of their own needs for something another has in abundance. The producer with an abundance of corn trades with the producer who has an abundance of fish and they are both better off than before. A carpenter works for a variety of farmers in exchange for some of their surplus goods and all are better off. In the current economic environment, the farmers, fisherman, carpenters and many other producers exchange their goods or services for money, but the principal is the same – voluntary exchange benefits those who participate in the exchange.

Then there are those who just take the goods and services they want from those who have produced those goods and services. In this type of exchange, the advantage of one is the loss of another. In early times, they were wandering warriors who lived by preying on more peaceful tribes. Over time, these warriors took on different mantles and found ways to legitimize their theft.

The German sociologist Franz Oppenheimer described this same issue in terms of the free market method and the political method of obtaining what we need.<sup>3</sup>

There are two fundamentally opposed means whereby man, requiring sustenance, is impelled to obtain the necessary means for satisfying his desires. These are work and robbery, one's own labor and the forcible appropriation of the labor of others.

I propose, ... to call one's own labor and the equivalent exchange of one's own labor for the labor of others, the "**economic means**" for the satisfaction of needs, while the unrequited appropriation of the labor of others will be called the "**political means**".

The State is an organization of the political means.

Throughout history people have been tempted to use the "political means" of seizing wealth rather than producing it themselves. Oppenheimer brilliantly defines the state, or government, as the "organization of the political means".

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<sup>3</sup> <http://www.franz-oppenheimer.de/state1.htm>

When any individual in a civilized society attempts to use the “political means” to acquire something of value from another, he is treated as a thief and is punished or is forced to make restitution to his victim. However, the government itself reserves the right to do what the individual is not allowed to do. The government can engage in theft, but when the government does it, it is called taxation - and it’s legal.

Gerald Carson, author of “*The Golden Egg*” observed that the temptation to resort to the political means has a long history.

The rudiments of the income tax may be discerned in primitive societies when public necessities, such as the common defense, began to be felt, and the chief of the clan or tribe was supported by gifts, either of service or property. These voluntary commitments were in time transformed into a legal obligation and their performance was brutally enforced.<sup>4</sup>

Without any opportunity for relief, excessive taxation will inevitably lead to either revolt or expatriation. According to the Encyclopedia of the Social Sciences,

“The first taxpayers’ revolt known to history (was) recorded on three clay cones and an oval-shaped plaque excavated by the French in 1878 at the site of the Sumerian city-state in Mesopotamia called Lagash. In the third millenium b.c. the Lagashites threw out the reigning dynasty and installed a new and presumably less expensive ruler.<sup>5</sup>

Charles Adams, author of “*For Good and Evil*”, tells us that oppressive taxes were common in ancient Egypt. He says,

“The tax story of ancient Egypt shows what happens in a society burdened with a totalitarian revenue system. The informer, the corrupt revenue official, and - most significantly - the tyranny of an all-pervading surveillance are inherent in such a system. ... The Egyptians used the scribes to oversee the pharaoh’s revenue system. The scribe was the substitute for the banking record, the computer, the tax-identifying number, and the other devices of the modern tax gatherer. ... The scribes were everywhere - snooping, inspecting, and recording.<sup>6</sup>

And, according to Carson, it was excessive and brutal taxes that were the real reason behind the decline of the Roman Empire.

Much of the story of western history revolves around the ongoing conflict between the efforts of various rulers to impose taxes on their subjects and the

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<sup>4</sup> Gerald Carson, *The Golden Egg*, 1977, Houghton Mifflin Co, page 13

<sup>5</sup> *ibid*, page 14, reference to the Encyclopedia of the Social Sciences

<sup>6</sup> Adams, *For Good and Evil*, Page 15

efforts of those subjects to throw off the yoke of excessive taxes. These conflicts had much to do with the evolution of English common law and with the ideas that influenced the framers of the U.S. Constitution.

Most people seem to believe that the income tax is an American invention. However, the British adopted a flat rate income tax to pay for the costs of the Napoleonic Wars in the early 1800s. According to Charles Adams,

The rate was 10 percent - proportional, not graduated - with a *grazioso* feature, which excluded from the levy the first 60 pounds of income. Repealed in 1802, the tax was re-imposed in 1803 when the war broke out again.

Carson echoes Adam's view.

In 1842, Sir Robert Peel's ministry, moving away from heavy indirect taxation and toward free trade, reinstated the tax. For three quarters of a century, the British income tax existed as a "temporary" measure. Gladstone, at last, in 1880 conceded that it was permanent.<sup>7</sup>

## The American Tax Revolution

While many Americans feel a bond with England as the primary source of our language, laws and culture, we also adopted many of England's destructive tax policies. Nearly all Americans are well aware of the famous Boston Tea Party that precipitated the revolt of the colonies against England. According to Shelley Davis, author of *Unbridled Power*,

The infamous Boston Tea Party prompted Parliament to enact even more punitive measures against the rebellious colonists, thus sealing their spirit of armed opposition to foreign domination and unwanted taxation.<sup>8</sup>

While most Americans have been taught that the United States was born out of the conflict between England and the Colonists, much of our history seems to have shifted the emphasis to the idea that our revolution was primarily motivated by a desire for political or religious freedom. What seems to have been forgotten is that it wasn't personal freedom that prompted the revolution - it was freedom from excessive taxes and from abusive tax collectors.

Part of the background behind the revolt of the colonies stemmed from the power of the British customs officers to search for smuggled goods by use of a legal device called a "writ of assistance". This device gave British officers the authority

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<sup>7</sup> Gerald Carson, Page 17

<sup>8</sup> Shelley Davis, *Unbridled Power*, 1997, Harper Collins Books, page 185

to engage in a search without a court order. Although it was not used extensively, Adams explains that,

The writ of assistance is important in American history because the threat of its use caused the founding fathers to place the great Fourth Amendment in the Bill of Rights. Although that great amendment is not now used to restrain revenue agents, it was initially adopted to do just that.<sup>9</sup>

At first, the successful revolutionaries attempted to use a loose confederation of the colonies as a form of government. However, the confederation had no power to obtain taxes to pay for the expenses of the Revolutionary War. Basically, the confederation had to rely on the voluntary financial support of the various colonies - much like the United Nations now has to rely on voluntary support from its members. As our own history proves, anyone who wants to prevent the United Nations from acquiring any real power should focus on preventing it from acquiring the power to impose any taxes on its members.

In the case of the fledgling colonies, there was an irresistible pressure to form a more cohesive union. As Gerald Carson observed,

The authority to tax is necessarily coupled with the power to coerce. Reluctant and apprehensive taxpayers often remind us of Chief Justice John Marshall's ominous words "The power to tax invokes the power to destroy." Yet a government lacking this power, which goes to the heart of sovereignty, cannot long endure. This explains the sense of urgency that spurred the delegates to the Constitutional Convention to produce a framework of a genuine federal union in which the taxing power was central to all other powers.<sup>10</sup>

To a great extent, the formation of a representative democracy by the colonies, with the carefully designed separation of powers between the Congress, the Courts, the President and the states represented a compromise between a desire for a stronger national government and the desire to protect the citizens from the natural tendencies toward burdensome taxation.

## **A Century of Low Taxes for Producers and Savers**

From the beginning of the nineteenth century until the Civil War, the government of the young United States relied primarily on customs duties and proceeds from the sale of federal lands. Except for the War of 1812, the new government had little need for large amounts of revenue.

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<sup>9</sup> Charles Adams, Page 296

<sup>10</sup> Gerald Carson, Page 19

The peaceful growth of the United States was jarred by the Civil War, which Charles Adams tells us was primarily due to a conflict over excise taxes, rather than over slavery. According to Adams,

One of the most popular myths in American history is that the Civil war was started over slavery. During his campaign for the presidency in 1860, Lincoln repeated time and again that he would not interfere with slavery in the South. There had been a prolonged struggle between the rich planters of the south and the rich industrialists of the North - and it was not over slavery.<sup>11</sup>

Secession by the South was a reaction against Lincoln's high tax policy. In 1861 the slave issue was not critical. Lincoln and the Congress gave unequivocal assurance that slavery in the south would be respected, yet the South would not budge from its secessionist plans.<sup>12</sup>

To help pay for the costs of the war, Lincoln pushed through an income tax, which - contrary to popular belief - was the first income tax in the United States. And, because of the war, there was no challenge to the tax based on the Constitution. Former IRS historian Shelly Davis describes for us the impact of that income tax.

Our present day income tax is one of the lasting legacies of the Civil War. In 1862, in the heat of the conflict, President Lincoln established the Bureau of Internal Revenue, the direct predecessor of today's IRS. The (Civil War) tax on income ... was shockingly progressive, exempting the first \$600 in income, and taxing income between \$600 and \$10,000 at the comfortable rate of 3 percent. Incomes above \$10,000 - enjoyed by only a handful or our most fortunate citizens - were taxed at a rate of 5 percent. An 1869 editorial in the New York Tribune denounced the income tax as "*the most odious, vexatious, inquisitorial, and unequal of all our taxes.*" .. (In 1872) the income tax was repealed.<sup>13</sup>

In spite of this brief experience with a progressive income tax, most of the nineteenth century was a period of very limited government, protection for property rights and negligible taxes. It was a century of great growth and comparative prosperity. In essence, the United States went through three generations without experiencing the oppressive weight of a government that had unbridled taxing powers. Given the tendency for people to assume that what is now will continue forever, there was a growing lack of concern over the power of government. And, everyone seemed to believe the U.S. Supreme Court could never agree to let the federal government expand its powers.

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<sup>11</sup> Charles Adams, Page 323-324

<sup>12</sup> *ibid*, Page 291

<sup>13</sup> Shelley Davis, Page 189-190

## Legalized Theft

The income tax that was introduced to pay for the costs of the Civil War was a temporary measure and was scheduled to expire in 1870. As Carson reminds us,

After the surrender at Appomattox, when patriotic fervor had subsided and government finances were improving, cordial feelings toward the income tax evaporated. ... Evasion of the tax was widespread.<sup>14</sup>

There was no appetite in Congress to continue the now unpopular income tax and it was allowed to expire. The Government resorted again to reliance on customs duties, an assortment of excise taxes and proceeds from the sale of federal lands.

Despite the general increase in prosperity resulting from a growing economy without the negative effects of high taxes, some segments of the populace were being persuaded that the rich of the day were evil predators who were depriving the poor from their fair share of the prosperity. The greatest danger of success in any undertaking is that the success will engender envy and resentment toward those who have accomplished more. The greater the accomplishment; the greater the resentment. It's apparently difficult for most people to accept the notion that making money is like any other endeavor. People have different skills and talents and there is no equality in terms of abilities. Just as only a very few people can be great athletes, great musicians, great artists or great scholars, only a few people have the talent and commitment to achieve greatness in business.

In the last decade of the 19th century and the first few decades of the 20th century, envy and resentment reached such proportions as to overturn the carefully constructed system of checks and balances created by the founders of the United States. The Populists were the political movement in this era who sought power and influence by pandering to the general feelings of envy or resentment toward the very rich of that era. According to Davis,

By the Gilded Age of the 1890s, Populists saw a soak-the-rich income tax as the ideal way to redistribute wealth from the grossly rich to the pathetically poor. ... During the financial panic of 1893, ...Democrat Grover Cleveland in the White House and Democratic majorities in both House and Senate threatened to join forces to push through a new income tax. ... The new tax would strike only the really rich: that 1 percent of the

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<sup>14</sup> Gerald Carson, Page 38

population with household incomes over \$4,000. (The Populist) faction won overwhelmingly, passing the 1894 Wilson Tariff Act, a bill Grover Cleveland grudgingly allowed into law without signing it.<sup>15</sup>

However, even though the 1894 income tax was extremely modest by modern standards, it was a discriminatory and direct tax which if unchallenged could be expanded at the whim of Congress. The wealthy of that day challenged the tax on Constitutional grounds, as being in violation of the apportionment clause. In 1895, the Supreme Court found the new tax to be contrary to the Constitution because, as Carson explains,

On May 8, 1895, the Court declared the whole law unconstitutional, by the barest of margins, 5 to 4, one justice having changed his opinion. The decision left the matter in this position: the income tax was a direct tax and could not be levied except on a basis proportional to the population of each state.<sup>16</sup>

The Populists were not about to let a little thing like the Supreme Court stand in the way of their plans to appropriate the wealth of the very rich and to institute socialistic policies in the U.S.

## The Sixteenth Amendment

Pressures for socialist forms of government were advancing throughout the industrial world. For those who are not clear on the temper of the times, the theories Karl Marx and Friedrich Engels espoused in "*The Communist Manifesto*" were published in 1848 and had been receiving a half century of attention by those who espoused the political means over the economic means. Lenin adopted the theories advanced by Marx and Engels to foster a successful but bloody revolution in Russia in 1917.

At that time, most reformers were still overtaken with the utopian ideals espoused by the communist and socialist movements and had not yet been forced to look at the brutal reality of totalitarian socialism. In the context of those times and the great disparity of wealth in the United States, Adams explains how

The advocates for income taxation pushed the Sixteenth Amendment through the state legislatures, giving Congress the power to tax income without apportionment. The new amendment succeeded because of assurances the rates would never exceed a few percentage points.<sup>17</sup>

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<sup>15</sup> Shelley Davis, Page 192

<sup>16</sup> Gerald Carson, Page 60

<sup>17</sup> Charles Adams, Page 364

Many opponents of the amendment were overly optimistic that it would never pass, but it was quickly approved by the required three fourths of the states. On February 3, 1913, Wyoming became the thirty-sixth state to ratify the Sixteenth Amendment. (Some members of the tax protest movement argue that the amendment was never properly ratified and some lawyers<sup>18</sup> don't disagree.)

The income tax law was passed so quickly it was not even set forth in a separate bill. Instead, it was included as part of a new tariff act, known as the Underwood-Simmons Tariff Act. Section II of that act assessed the new income tax, along with hundreds of provisions setting the rate of excise tax on such diverse items as bauxite, gloves, and even wild animals for sale. It was approved on October 3, 1913. Those who object to the imposition of retroactive taxes will be appalled to discover that the effective date of the first permanent income tax was seven months before the date the law was passed.

Although the new income tax law was quickly challenged on Constitutional grounds, Charles Adams tells us "The Court disposed of the question with not much more than a one-liner".<sup>19</sup>)

## Rapid Expansion of the Income Tax

At the time the new income tax was being pushed through the state legislatures, the political leaders of the time were concerned that the United States would be unable to avoid being dragged into the escalating conflict in Europe. Some efforts were being taken in advance of actual involvement in the war to be better prepared for that eventuality.

War has always been a primary reason for imposing higher taxes and World War I resulted in the rapid escalation of tax rates under the new income tax system. According to Charles Adams,

The first income tax law had a 7 percent maximum rate, which was changed to 15 percent in 1916. In 1917, it jumped to 67 percent, then 77 percent. When these ultrahigh rates hit, high incomes quickly began to disappear, 'as if by magic'... the Treasury reported 206 million-dollar incomes in 1916, when the (top) tax rate was 7 percent. In 1921, when the (top) tax rate was 77 percent, only 21 million-dollar incomes were reported.<sup>20</sup>

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<sup>18</sup> Attorneys with whom the author is familiar

<sup>19</sup> Charles Adams, Page 368

<sup>20</sup> *ibid*, Page 380

## A brief respite in the 1920s

After nearly five years of bloody and costly conflict, the “War to End all Wars” came to an end on November 11, 1918. The aftermath led to postwar boom and a brief period of relative peace and prosperity. During that time, the tax rates were increased from a high of 7 percent to a high of 77 percent and the various exemptions were greatly decreased.

As Gerald Carson points out, “Any thoughtful reader searching for a rationale to explain the extraordinary vitality of the income tax can easily find it in one word: **war**.<sup>21</sup>”

## The Roaring Twenties

Shelley Davis commented on the status of the income tax at the end of the war and the beginning of the tumultuous era of the 1920s.

By the dawn of the Roaring Twenties the income tax had become the federal government’s main source of income. The income tax still remained strikingly progressive. ... The rich, who a decade before had paid hardly any taxes at all, were now, to their chagrin, shouldering the lion’s share of the burden. But once marginal rates soured to the 70-percent level, the rich began aggressively sheltering income into tax-exempt state and local bonds while furtively shifting assets into personal holding companies taxed at the lower corporate rate. The result was that revenues ... dropped even as rates soared.<sup>22</sup>

In addition, the well-to-do secured the political support of the rapidly growing middle class and upper middle class to swing the popular vote back to the fiscally conservative Republicans. The Populists and the Democrats had sold the public on the Sixteenth Amendment with promises that the top tax rate would never exceed ten percent and the income tax would only apply to the wealthiest citizens. Unprepared for the political backlash and without a war to encourage the populace to agree to confiscatory tax rates, the Populists and Democrats lost the elections and the Republicans quickly reduced the top tax rates.

Andrew Mellon was then Secretary of State and he was an early practitioner of what has now become known as “supply-side economics.” According to Shelley Davis,

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<sup>21</sup> Gerald Carson, Page 106

<sup>22</sup> Shelley Davis, Pages 194-195

Having keenly observed that railroad freight rates were traditionally set at a level known as “what the traffic will bear”, (Treasury Secretary Andrew) Mellon sharply cut tax rates three times in ten years. As a result, overall revenues in fact rose.<sup>23</sup>

In addition to a roll back in the top rates, Mellon was able to push through a reduced tax rate of 12.5 percent on capital gains, which had previously been treated the same as any other income.

## **World War II and the U.S. Income Tax**

Wars have provided the primary need for more government revenue and the strongest justification with which governments can extort more money from their citizens. For all but a few hardy souls, when the robber says, “Your money or your life”, most sane people will give them their money. And, when a foreign power threatens our own government, we seldom feel there is any more of a choice about giving up more of our property and our earnings.

The Second World War provided the stimulus to jump-start a lagging economy as well as the stimulus for much higher tax rates and much lower exemptions. Before the war, fewer than five percent of the people were subjected to the income tax. By war’s end, nearly everyone would be subject to the much expanded income tax. There was a new tax law nearly every year during the war and each new law escalated the tax rates while subjecting more and more people to a tax originally intended only for the very rich.

According to Gerald Carson,

The Revenue Act of 1941 in September (1941) lowered exemptions once more, boosting surtax rates to curb war profiteering and inflation and to help pay for the national mobilization. New millions of Americans felt for the first time the weight of income taxation; war and taxation, as always, being bonded together and receipts always falling behind expenditures.<sup>24</sup>

The most significant change in the tax law during the war years was the introduction of the withholding tax. Before the income tax was withheld at the source, taxpayers had to pay the amount due in quarterly installments in the following year. Having to write a check for the full amount of the income tax was a constant reminder of how much the government was taking. Richard Goode, author of *The Individual Income Tax*, observed that

The enforcement of the income tax has been greatly aided by withholding of tax on wages and salaries. ... Withholding could be extended to

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<sup>23</sup> *ibid*, Page 195

<sup>24</sup> Gerald Carson, Page 123

dividends, interest and certain other periodic income payments, as in many countries, but Congress has rejected proposals for doing so.<sup>25</sup>

The impact of the withholding tax, combined with the decrease in exemptions and deductions made a much larger number of citizens subject to the income tax. According to Shelley Davis, the tax revenue increased nearly seven fold - from \$7 billion annually to \$45 billion by 1945, and well over 50 million Americans were then paying their dues involuntarily, via withholding.

## **The Cold War Tax and Some Relative Stability**

Unlike the income tax of the civil war, the income tax that evolved during the first and second world wars did not die a peaceful death after the war. By now, the income tax was deemed constitutional by the courts because of the Sixteenth Amendment and the extension of the tax to the general public had been accepted during the course of the Second World War. In addition, the withholding tax made the majority of employed taxpayers unaware of the full amount they were really paying.

After the war, there was a pent up demand for housing, cars and many other amenities of life that had developed during the period from 1930 through 1945, and the population was exploding during the baby boom of the post war years. All of this led to an economic boom that produced another rising tide that provided more for everyone. But government was the principal beneficiary of these convergent forces. According to Gerald Carson,

The revenue yield ... after (World War II) was determined principally by the resultant of two forces: the rate fixed for the first bracket and the level allowed for personal exemptions. An adjustment up or down of only \$100 in exempt income was sufficient to move billions of dollars into or out of the Treasury. The income tax was the most productive, it was found, when it reached the largest areas of income -- not the largest incomes --- for the lower income taxpayers taken collectively, had the most money. (From 1940 to 1945), the number of returns rose by more than 350 percent while the population grew only 6 percent.<sup>26</sup>

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<sup>25</sup> Richard Goode, *The Individual Income Tax*, 1976, Brookings, Institution, page 33

<sup>26</sup> Gerald Carson, Pages 129-130

## Tax Avoidance and Tax Evasion

The tax law draws a sharp distinction between tax avoidance and tax evasion. Avoidance is legal, whereas evasion is not. Supreme Court Justice Sutherland explained that,

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid, by means which the law permits, cannot be doubted.<sup>27</sup>

Charles Adams claims that,

Tax evasion is probably the oldest profession, despite the claims of the ladies of pleasure. There is no civilization that did not tax, and there are probably no taxes that haven't been evaded.<sup>28</sup>

Gerald Carson also believes that tax evasion is widespread but not limited to the lower income segments of society. He says,

Who evades? Steeplejack, gravedigger, lawyer, undertaker, society matron, prostitute, corporation executives, ... small businessmen, abortionists, loan sharks, drug traffickers - all have been objects of prosecution. Occupations in which cash changes hands regularly are subject to special temptations, as the IRS well knows.<sup>29</sup>

Nor does it seem there is anyone who has not evaded some income, however modest the crime might be. Charles Adams says that,

Lie detector operators in North America often ask subjects if they cheat on their taxes. The reaction to this question is usually intense, which gives the polygraph operator an insight into the emotional responses of the subject.<sup>30</sup>

When any government seeks to impose onerous taxes on their citizens, the citizens who have sufficient wealth to take protective measures will do so. One of the oldest known methods of tax avoidance is the use of tax havens. As described by Charles Adams,

Tax havens are inevitable whenever taxes are too high. In the later Roman period, hordes of Roman taxpayers went over to the barbarians to avoid Rome's ugly tax enslavement. ... Islam was a tax haven to

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<sup>27</sup> Gregory v Helvering, 294 U.S. 465 (1935)

<sup>28</sup> Charles Adams, Page 393

<sup>29</sup> Gerald Carson, Page 155

<sup>30</sup> Charles Adams,. Page 397

Christians in the seventh and eighth centuries. The first tax haven in the post medieval world was America. Historians readily acknowledge that more people fled from Europe to the New World to avoid Europe's hated taxes than for religious or political freedom.<sup>31</sup>

But starting in 1962, the government has changed the laws that made the use of tax havens a form of tax avoidance and has made their use a form of tax evasion. Today, there are very few legal ways to avoid or to defer taxes outside the U.S. unless you relinquish your citizenship (or green card status<sup>32</sup>).

The tax law makes a distinction between evasion and avoidance based on two primary elements. First, avoidance is permitted so long as it stays within the bounds of the law. Second, if the taxpayer does step outside those boundaries, he must do so with the intent to evade. This requires that he first knows what the law requires and then that he willfully did not comply with the law. Gerald Carson reports on two cases that help to make the distinction. Carson tells us that

A North Carolina accountant lost his case because the court held it was a decisive factor that he knew what he was doing when he failed to keep accurate records. ... (But) the Tax Court threw out fraud charges against a Springfield, Ohio turkey farmer because he had only a sixth grade education.<sup>33</sup>

However, in recent years, the IRS and the courts have blurred the distinction between legal tax avoidance and illegal tax evasion. The IRS treats what they call "abusive" tax avoidance as being the same as tax evasion. Nonetheless, the Constitution still provides some protection for those charged with criminal tax evasion but does not extend Constitutional protection to penalties, interest or other sanctions for over-zealous tax avoidance.

## **Inevitable Abuses of Power by the IRS**

While the Congress is the primary culprit behind the continually changing and ever more complex tax law, as well as the continually increasing tax burden, their collector and watch-dog, the IRS, has been pouring gasoline on the fire of taxpayer discontent. Charles Adams relates a story of two successful Russian immigrants that explains the problem well.

A few years back, on a talk show in the United States, two recent Russian immigrants who had become very successful and were making a lot of

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<sup>31</sup> *ibid*, Page 406

<sup>32</sup> Aliens who secure permanent residence status in the U.S. used to be issued a green card to identify their legal status.

<sup>33</sup> Gerald Carson, Page 159

money were asked about their new life in the West and the freedoms they now enjoyed. After expressing appreciation for all these aspects of western living, they started in on the IRS, stating that not even in Russia was there such an operation that could take over half of what you had earned.<sup>34</sup>

Of course, the IRS does not have the unilateral power to decide on what the tax rates should be, nor what the varied exemptions and exclusions should be. While they are charged with the duty to implement the internal revenue laws as enacted by Congress, they have generally adopted a protagonist position, acting as the keeper of the gate to the U.S. treasury.

While the IRS Commissioners have been fond of regaling anyone in hearing range with the marvels of the “voluntary” tax system in the U.S., they engage in a methodical process of disinformation and intimidation to secure the voluntary compliance they like to extol. Gerald Carson explains how,

It became one of the rites of spring for the Commissioner of Internal Revenue to issue dire warnings citing the penalties that could be imposed by the agency, including warrants of distraint permitting seizure and sale of property of delinquents. ... The Bureau’s annual foray into psychological warfare made solemn reading, often heightened by the spectacular indictment and/or the conviction of some prominent citizen.<sup>35</sup>

One might feel some sympathy for the tax collectors who bear the brunt of the taxpayer’s ire at the taxes imposed by Congress if they hadn’t worked so hard over the years to earn the enmity of the public. Perhaps anger at tax collectors is unavoidable. Carson tells us that during the Roman Empire,

Marcus Tullius Cicero, ... classified tax gathering as a sordid occupation, along with the tasks of butchers, cooks, sausage-makers, fishmongers, and stage-dancer. (Carson- pg 193)

Of necessity, the IRS employees who have the most contact with the public must have a thick skin and great resistance to both hostility and pleas for leniency. One of the ways the field agent is indoctrinated by the organization is by convincing the new IRS agent that every citizen cheats on his taxes. And, over time, the field agents do encounter enough outright fraud, and minor dishonesty to come to believe that there are no really innocent taxpayers. The agents who last more a few years therefore tend to become immune to both the hostility and the pleas for leniency directed at them by taxpayers.

Another reason why most citizens have good reason to resent the tax collectors is because the IRS has adopted an advocacy position with respect to the public

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<sup>34</sup> Charles Adams, Page 396

<sup>35</sup> Gerald Carson, page 111

treasury. They assume that each taxpayer and the taxpayer's advisors will take a position most favorable to the taxpayer and that to balance the scales, the IRS must be the advocate of the public purse. They therefore don't attempt to implement the intent of Congress - they attempt to implement an interpretation of the laws that will result in collecting more money from the public. Many IRS agents are as ingenious and clever in proposing novel theories of law as their counterparts who represent the taxpayers.

In their self-defined role as aggressive advocates of collecting more taxes from every taxpayer, the agency soon learned that they can outspend any individual taxpayer in a legal contest. So they use the threat of extended legal contests to extort concessions from taxpayers who may have wholly justifiable grounds for challenging the antagonistic posture of the agency. The IRS has been known for many years to litigate issues in different judicial districts even when they have lost the same issue in other districts. If the Tax Court makes a decision with which they don't agree, the IRS can elect to ignore an adverse decision as a legal precedent - and they often do. Thus, taxpayers rightly feel they are the proverbial David in a battle with Goliath.

Moreover, the career employees of the agency prefer to conduct their business without the scrutiny of the Congress and certainly without any oversight by the fourth estate. To these ends, IRS Historian Shelley Davis tells us that

The IRS negligently and deliberately destroyed its paper trail, shredded its records, and trashed any chance for accountability, out of some ill-founded and irrational fear of exposure to public scrutiny.<sup>36</sup>

The IRS runs from its past, evades its responsibilities, coddles criminals, lies to Congress, retaliates against whistle blowers, and squanders the billions it receives in taxpayer's funds on incompetent management schemes, cushy offsite management seminars at top-notch resorts, and computer systems that don't work and cost plenty.<sup>37</sup>

Despite the near floodtide of exposes about abuses of its authority and power, there is little chance the Congress will put an effective muzzle on their watch dog. After all, if you were trying to convince a lot of people that they had to give you as much as 35 percent of their income, you would need a lot of strong arm type collectors to get the money.

## Expatriation

When combined with the frustrations of trying to get an impartial treatment from an overtly protective and abusive organization of tax collectors, plus the growing

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<sup>36</sup> Shelley Davis, Page 3

<sup>37</sup> *ibid*, Page 8

trend away from socialist structures in other countries, some taxpayers began to find citizenship in other countries to be much more attractive.

For most of the first 100 years of its existence, the United States was a Mecca for those seeking to secure freedom from preposterously high taxes. Charles Adams puts the issue of patriotism and expatriation into a long term perspective.

Patriotism is soluble in taxes - it dissolves easily. Flight to avoid tax has been a major force in the emigration of people from their homeland.<sup>38</sup>

The list of notables who have fled their homeland to avoid heavy taxation would read like an international "Who's Who". Flight is the number one device used by wealthy people to avoid heavy taxation. It is not as dramatic as rebellion and violence, or as intriguing as fraud, but it is safe and seldom illegal. In the declining years of the great empires of Egypt, Rome and Imperial Spain, the flight of taxpayers reached epidemic proportions.<sup>39</sup>

For most of the history of the United States, there were few alternatives in the world that offered greater freedom and opportunity than the U.S. But, with the breakdown of many socialist systems, many smaller governments began to reach out to venturesome entrepreneurs and investors who would bring them both capital and jobs for their residents.

While the number of U.S. citizens and permanent residents who are giving up their citizenship is not yet at an alarming number, the Congress became sufficiently concerned in late 1996 that they introduced what is essentially an exit tax. A bill was passed by the House and Senate in 1995 that included a provision to impose capital gains taxes on the unrealized gains of any citizen or long term resident who gave up their citizenship or residency for tax reasons. However, President Clinton vetoed that bill for other reasons and the Congress didn't override his veto.

But, then, in the Omnibus Budget Bill that was enacted soon after the health care bill, the following provision was included and is now included in [INA §212\(a\)\(10\)\(E\)](#).

Any alien who is a former citizen of the United States, who officially renounces U.S. citizenship and who is determined by the Attorney General to have renounced U.S. citizenship for the purpose of avoiding taxation by the U.S. is excludable (from returning to the U.S.)

Gideon Rothschild, a tax attorney in New York said that this new law

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<sup>38</sup> Charles Adams, page 448

<sup>39</sup> *ibid*, Page 389

Effectively puts expatriates in the same category as Nazi war criminals, terrorists and others whose re-entry into the U.S. can be prohibited.

However, there is no indication that this rule has been enforced.

Relative to the proposed exit tax on unrealized gains, another commentator pointed out that only the former Soviet Union and Nazi Germany had adopted similar expatriation taxes. Most likely, the U.S. politicians are well aware that the breakdown of socialist systems around the world is making other countries look far more attractive to U.S. entrepreneurs. The loss of these people, and their money, is likely to be greatly feared by the politicians who still don't understand that you can't foster ambition and creativity in a prison.

After more than ten years of repeated attempts to impose a capital gains tax on all unrealized gains and an income tax on any tax deferred income of expatriates, the Democrats succeeded in June of 2008. As of June 17th, the President signed the bill<sup>40</sup> to which this provision was attached. After that date, any U.S. citizen or long term resident who expatriates with

- (1) a net worth of \$2 million or more
- (2) an average tax liability for the past 5 years of \$124,000 adjusted for inflation or
- (3) does not certify that he/she had complied with all of their tax obligations for the past five years and does not submit an expatriation information form

will be subject to a tax on the fair market value of their assets minus the adjusted cost (basis) of those assets and any deferred income. However, the first \$600,000 of gain is not taxed. Special rules will apply to tax deferred income such as savings in a tax qualified retirement plan. Individuals or long term residents who expatriated before June 17, 2008 will be subject to the expatriation rules in effect before passage of this new exit tax.<sup>41</sup>

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<sup>40</sup> The Heroes Earnings Assistance and Relief Tax Act of 2008 (H.R. 6081)

<sup>41</sup> Internal Revenue Code section 877A

## Prospects for Tax Reform

The politicians have been promising tax reform and simplification since the early 1960s. But every year the tax code and the IRS regulations just get bigger and bigger; the law gets more complex and taxpayers get more frustrated. In 1986, President Reagan and the Republicans pushed through a comprehensive reform package that reduced the top personal tax rate from 50% to 28% and introduced a two bracket tax system starting after 1987. The two rates were 15% and 28%. But that law also attempted to cut out a lot of tax breaks for investors that were known as “tax shelters”. And that law did not eliminate the alternative minimum tax or index the AMT exemptions for inflation. Overall, the Tax Reform Act of 1986 did not come close to making anything less complicated. And in a few years, the process of adding tax brackets and special tax incentives (loopholes) began again.

### Is Tax Reform Possible?

What are the reasons why we can't seem to accomplish fundamental reform when “everyone” seems to be in favor of tax reform?

One of the reasons is because tax reform, like beauty, is in the eye of the beholder. One person's tax incentive is another person's loophole. The populace is nearly split in half over the direction they want the tax system to take. Here are just a few of the many obstacles to long term and fundamental tax simplification.

#### => Voters Who Depend on Federal Funds

If your livelihood depended on a tax incentive, a deduction or even on the revenues generated by the income tax, would you be willing to give up your tax break or government income in exchange for a mere promise that others would also lose their tax breaks or government subsidy and everyone would somehow be better off?

What if you were retired and didn't have enough savings to generate enough income to maintain your life style? Would you vote in favor of eliminating the Social Security and self-employment tax? What if you and your spouse had three living parents all of whom needed extensive medical care? Would you be willing to make huge cuts in the budget for Medicare and Medicaid? If you have a parent or other loved one who needs long term care in a nursing home (or an assisted living facility) would you vote to eliminate or cut back Medicaid?

There are approximately 3 million federal employees and about 20 million employees of all levels of government.<sup>42</sup> To a large extent, many of the jobs of the state and local governments are dependent to some extent on federal subsidies or revenue sharing. If the income tax were eliminated, what would happen to those jobs? Proponents of tax reform and of cutting spending argue that the private sector would absorb these government employees. But how long would it take? Would you vote for a tax plan that would make huge cuts in the number of government jobs? What if you were a government employee? Or do you have a parent, brother, sister or child who is a government employee?

The [International Herald Tribune](#)<sup>43</sup> claims that the government spent over \$400 billion on outside contractors in 2006. Assuming an average annual salary with benefits of about \$50,000, that's roughly equal to about 8 million jobs. When you add the impact of sub-contractors, that's a lot of people who have a vested interest in the status quo.

Without the present tax system, what would become of the indigent? According to [SecondHarvest.org](#),<sup>44</sup> there are 37 million people in the U.S. who are considered to be in poverty. Some people believe this number is greatly exaggerated and others argue that if the government didn't provide support it would be provided by relatives and private charities. I can't find any statistics on how many people who are impoverished are also taking the time to vote, but the people who claim to be concerned about those in poverty do vote and many of them are politically vocal.

Some people claim that the tax industry is a major deterrent to tax reform because reform would eliminate their jobs. But the [Bureau of Labor Statistics](#)<sup>45</sup> is reputed to have identified 86,000 tax preparation jobs in 2004. Even when you add in the number of tax lawyers and tax publishers and their employees, the numbers are hardly enough to make a dent in an economy of some 100+ million jobs.

The number of public charities and private foundations is not overwhelming either, but their influence extends far beyond their numbers. All of the major donors would be affected by the elimination of the income tax and the deduction for charitable contributions. This would include educational and medical institutions that depend to some extent on contributions or endowments.

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<sup>42</sup> [http://www.data360.org/dsg.aspx?Data\\_Set\\_Group\\_Id=228](http://www.data360.org/dsg.aspx?Data_Set_Group_Id=228)

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<http://www.iht.com/articles/2007/02/04/america/web.0204contract.php>

<sup>44</sup>

[http://www.secondharvest.org/learn\\_about\\_hunger/fact\\_sheet/poverty\\_stats.html](http://www.secondharvest.org/learn_about_hunger/fact_sheet/poverty_stats.html)

<sup>45</sup> <http://careers.stateuniversity.com/pages/185/Tax-Preparer.html>

Unions enjoy an indirect benefit from the income tax. Government laws provide protection for unions from efforts by employers not to hire union employees or to engage in discriminatory treatment of union members. The protections provided to unions by government are largely dependent on the money the government derives from the income tax.

### **=> Economic Liberals, Populists & Socialists**

Recent elections have shown that the U.S. voters are closely divided between those who support a policy of free markets, minimum taxes and personal privacy and those who believe that government can solve problems through informed micro-management of the economy. A great many people appear to believe that the proper role of government is to prevent bad things from happening. They believe that government should somehow prevent poverty, crime, illness, injury and every other conceivable manner in which bad things happen to good people.

Every time the talking heads on the news shows tell us about some kind of disaster that has befallen a person or family, they typically conclude their comments by claiming that the government didn't do a good job of regulating the situation that led to the problem, or they announce in somber tones that the government should do something to prevent such things from happening.

Despite the glaring failures of the Soviet economy there are still a great many people in the U.S. who march to the beat of a socialist drum. They want the government to force everyone to be economically equal rather than to merely provide an environment where everyone has an equal opportunity.

Close behind them are the populists who pander to the greed and self-interest of various groups that believe they have somehow been deprived of their fair share of the great wealth of this country.

And then there are the elite liberals who mostly believe they are smarter than the rest of us and should be able to devote their time to engage in reading, writing, traveling, dining and other activities of those who don't need to work. But many of them haven't inherited a fortune to permit them to live an aristocratic lifestyle so they argue that government should allow them to be the managers of the economy for the benefit of all. Why should they be the managers? Because they believe they are smarter than the rest of us.

All of these groups are likely to resist any serious effort to radically change or to eliminate the income tax. It was the socialists, communists and populists of the early 20<sup>th</sup> century who pushed through the 16<sup>th</sup> Amendment. And their progeny is still with us.

### **=> Politicians Derive Power & Influence from the Income Tax**

The most important task of a politician as soon as he or she is elected is to find ways to ensure that he or she will be re-elected when the current term expires.

The politicians who are involved in the tax writing committees are in the most enviable position to ensure their re-election. They can bury obscure tax breaks in the law for the benefit of their supporters. They are the most heavily lobbied members of the Congress. They can make deals with influential members of other committees who control bills that can be beneficial to their constituents or supporters.

And hardly anyone ever knows how these deals are done because the tax law is so complex and hard for people to understand. The law is written in an arcane regulatory language where a single paragraph may contain multiple references to the tax code sections of other parts of the law as a way to conserve space and to get the most consistency in the wording of the law.

As one very simple example, the first sentence in the tax code sets forth the tax rates for married persons filing a joint return. This section states .....

*(a) MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES --- There is hereby imposed on the taxable income of—(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and (2) every surviving spouse (as defined in section 2(a), a tax determined in accordance with the following table”*

If you look up section 7703, it defines marital status but it also cross-references two other code sections. And section 6013 goes on for a page and a half of fine print to define a joint return – with dozens of cross-references to other sections of the tax code. And this is one of the least complicated parts of the tax code.

It's entirely apropos that it is called the tax “code” because reading it is a lot like trying to decipher a message that is written in a secret code like those used in the spy stories and in war time.

This “code” gives the politicians the ability to bury obscure tax breaks in the law for the benefit of favored supporters and constituents. And they enjoy that ability to convey benefits without the glare of publicity. They have no desire to change a tax system that is so conducive to keeping them in office.

### **=> The Elusive Meaning Of “Income” Complicates Reform**

As an accountant, I can hardly think of a worse foundation on which to build a tax system – from a taxpayer's point of view – than a tax based on income.

Almost everyone thinks they know what income is when they receive it but few people can define it with any accuracy. Most employees tend to think of income as being the wages they receive. But the varied benefits provided by employers are also income – even though they might not be taxable. For those who are self employed, gross income is the revenue they receive, but that's not their economic income or their taxable income. The self employed need to reduce their gross income by the cost of the merchandise they sell or the labor costs of their employees and by an assortment of expenses for such things as rent, utilities, transportation, advertising, office employees, etc. etc. And what about the cost of land, buildings and equipment that are purchased instead of being rented? From a tax perspective all three are subject to different rules. Land isn't deductible at all until it is sold. Buildings are depreciated over a long period of time and equipment (subject to some limits) is fully deductible in the year acquired.

Nearly every industry has a different way to measure its income. The income tax law tries to accommodate these differences but doing so appears to convey tax breaks for one industry over others.

Some accountants might disagree with me, but I believe you could easily generate a heated debate among accountants as to the fundamental definition of income, which would apply to everyone. If you got a few economists in the argument, the noise level would increase dramatically. And except for a few lawyers who actually took a course in basic accounting, their ignorance of the concept of income is about the same as most accountants' ignorance of the law of agency or criminal law. In the international realm, different countries use different methods of measuring income.

This ambiguity gives the tax writing politicians a marvelous tool to manipulate the tax definition for the purpose of conveying special tax breaks to different groups or to collect more tax revenues from different (i.e. higher income) taxpayers. They can use the tax law and the vagueness of the meaning of income to reward friends and punish enemies. If you were a professional politician, would you give up such a valuable tool without a lot of resistance?

### **=> Consumers And Their Advocates Will Resist A Consumption Tax**

One of the alternatives to the income tax is a national sales tax or a value added tax. This imposes the tax burden on consumers rather than on those with income. A brief discussion of the "Fair Tax" is included later in this report but in terms of resistance to change, we need to remember why the income tax was adopted in the first place.

Until the 16<sup>th</sup> Amendment was passed, the federal government was limited to the use of excise taxes, import duties and proceeds from the sale of land as a source of revenue. Most of this relatively modest tax burden fell on consumers and

there was a great deal of anger by many consumers about the huge profits of the industrialists in the Northeast that were not subject to a tax. A combination of Socialists, Communists, Populists, farmers and ranchers pushed for an income tax to tax those “robber barons”.

According to the [National Taxpayers Union](#), in 2005 the taxpayers in the bottom 50% in terms of adjusted gross income only paid 3% of the federal income tax. Of course, the lower income taxpayers do pay Social Security taxes and an assortment of federal excise taxes that are built into the price of various goods such as gasoline, tobacco, telephone services and wagering. So those in the lower half of the economic pyramid won't be excited about a national sales tax. In addition, the growing number of retirees is likely to resist a national sales tax because they are now living on savings. Some of their savings have already been subjected to the income tax and if a national sales tax is passed, their after-tax income will be taxed again when they spend the money.

## What is a “Fair Share” ?

In more than 40 years of helping people with their tax returns, nearly every one of them has made the effort to let me know that they don't object to paying their “fair share” of the income tax, but they don't want to pay any more than the law requires. I learned a long time ago not to confuse them with the fact that a “fair share” isn't the same thing as what the law requires. The reason is because the law can be – and often is – abundantly unfair, based on various concepts of fairness. So what is a “fair share”? Like beauty, it is in the eye of the beholder and what is fair to you may seem patently unfair to your neighbor.

### => An Equal Amount For Everyone?

Charles Adams believes that the founders of the U.S. intended that taxes should be equal in amount in the sense that the tax should be uniform. The Constitution was written to expressly prohibit the Federal government from imposing a tax directly on the citizens of the various states. Thus, the founders appear to have believed that a “fair share” is an equal tax without regard to differences in the wealth of different citizens. However, the Constitution did not prohibit the Federal government from imposing excise taxes or duties on goods based on the quantity or value of the goods being taxed. Thus, the taxes imposed were not equal in the amount of the tax. And it would be nearly impossible to implement such a tax.

Whatever the equal amount might be, there would be some citizens whose income was less than the tax. They would have to be exempted. But that would result in dividing the tax among fewer people, which would increase the amount for everyone. That would result in having additional people who could not pay the higher amount and would also have to be exempted. This would continue until the amount of the tax was so large that no one could pay it.

**=> An Equal Percentage Of Some Common And Measurable Value?**

What would work would be a tax based on an equal percentage of some measurable quantity or value. That's precisely what a consumption tax does.

The "Fair Tax" (discussed below) is predicated on imposing a single tax rate on all goods and services. A value added tax (VAT) is a similar concept except that the tax is imposed at each stage of production and distribution of products with a deduction being allowed for the amount of the VAT that is included in the cost of goods purchased for production or resale. Most of the European countries and many others in the world utilize a VAT – in addition to an income tax.

**=> Progressive Tax Rates**

A large part of the voters in the U.S. seem to believe that those with more income should pay a higher rate of tax than those with less income. This concept is described as a "progressive" tax system partly because it is promoted as being more enlightened but also because of the arithmetic progression of the tax rates with increases in income levels.

This concept is also described as class warfare and as simple envy. Clearly, all but a very few high-income people are going to agree that they should have to bear a much higher percentage of the tax burden than everyone else. According to the Congressional Budget Office, the top 5% of the citizens in terms of income pay about 50% of the income taxes.

In spite of this often-cited fact, the far left and their media friends continue to argue that that the "rich" aren't paying their fair share. They also argue about tax cuts being for the benefit of the rich – which is true because only the rich are paying income taxes. How in the world can a tax cut benefit those in the bottom 50% of the income earners who are not paying any income taxes?

**=> Taxes On Corporate Revenues Or Profits**

In addition to the income tax on individuals, the U.S. (and most other countries) imposes an income tax on corporations. Part of the argument in favor of doing this is that owners of small corporations could simply let their corporate profits accumulate instead of taking that income as a dividend or a salary.

Some people argue that taxing corporations is like a sales tax because the corporation just increases the prices it charges its customers. But few businesses are able to simply raise prices whenever they wish, because of competition with

other businesses. To the extent that all businesses are subject to the same tax, then they will all raise their prices and the burden will fall on the consumers.

But that argument falls apart for large corporations. When large corporations make decisions about what to do with their profits, they can choose between paying some dividends, increasing the pay or bonuses of their employees, using the profits to build new plants or to buy new equipment, using the profits to buy shares of other corporations or even making a decision to cut their prices. When a tax reduces their profits, that tax burden falls partly on shareholders, partly on employees and partly on the consumers of the corporation's products.

But from a political perspective, the reason corporations pay an income tax is because corporations don't vote and they control a lot of money.

## **Alternative Tax Systems**

One of the many problems in trying to reform our tax system is that there are so many different ideas about what should take the place of our current system. Another problem is the relative prosperity of Americans. When you are struggling to put food on the table and to pay the rent or the mortgage, a few dollars of tax make a big difference – and often lead to revolutions. But when you have a comfortable home with a separate room and bath for every member of the household, with a tv in every room and two or three cars in the driveway, a small tax increase is less important than focusing on the job that has provided the economic prosperity you enjoy. A larger tax increase may be very disruptive to your lifestyle, but giving up a trip abroad or not being able to buy a new boat this year isn't worth joining the revolution. So to a large extent, prosperity breeds a higher degree of apathy with respect to government and taxes.

Here is a brief description of the various tax reform methods being advocated today.

### **=> Flat Rate Income Tax & Simplification**

A lot of tax reform advocates aren't concerned about getting rid of the income tax and the IRS. They just want to have a less complicated tax system and to have a single tax rate for everyone. Some of the advocates of a flat rate income tax are willing to accept revenue neutrality in order to do this. For those who may have recently migrated from Mars, "revenue neutral" simply means that the government continues to consume the same amount of our income, and those who are beneficiaries of the annual deluge of federal money won't have to worry about losing their particular benefits, jobs or contracts.

However, we seem to have a very short-term memory or a resistance to studying any history – even as recently as 1986. The 1986 tax law introduced a two-bracket income tax. It didn't include much simplification and can even be said to

have more than doubled the complexity of the income tax. But it did eliminate all but two of the tax brackets. And it didn't last much more than a year. The ink was hardly dry on the 1986 tax law when the Congress began to add back some brackets and to tinker with the details of the '86 law.

### **=> National Sales Tax – “Fair Tax” With Revenue Neutrality**

The “[Fair Tax](#)”<sup>46</sup> is a widely promoted national sales tax system that is described as a progressive and revenue neutral national sales tax. It's deemed to be “progressive” because it includes a tax “pre-bate” to offset the effect of the tax on the poor. The “pre-bate” is simply a check that would be written by the federal government to everyone regardless of income. The amount of the pre-bate is intended to offset the national sales tax on income below the poverty level.

In order to make the “Fair Tax” revenue neutral, the promoters claim that it would require a sales tax rate of 23% based on the amount of spending subject to the tax. Some commentators argue that this is effectively equal to a 30% tax on income because an income tax is inclusive whereas a sales tax is exclusive (not included in the base amount). The “Fair Tax” advocates repeal of the 16<sup>th</sup> Amendment but this would be accomplished with “companion legislation”.

Conservative and Libertarian opponents argue that it doesn't make sense to change the tax system if the government will have the same amount of dollars to spend. Liberal opponents argue that the “Fair Tax” burden will fall mostly on the poor because they spend all of their income. And those who want to repeal the 16<sup>th</sup> Amendment argue that there is no assurance that the companion legislation would be passed even if a national sales tax is adopted. And we could end up with both an income tax and a national sales tax.

Advocates for the over 65 part of the population argue that retirees have already paid an income tax on their retirement savings and will now have to pay taxes on the money when they spend it, thereby taxing this income twice. To the extent that retirement savings is in the form of tax deferred employer pension benefits, 401k plans, IRA savings or other tax deferred income, this double tax argument doesn't hold up.

### **=> Cut Spending First – Ron Paul & Libertarians**

Dr. Ron Paul (R-Tx), one of the candidates for President in the 2008 elections, is an advocate of cutting spending and repealing the 16<sup>th</sup> Amendment and returning the U.S. to the gold standard. His argument against revenue neutral tax reform is that the problem is not the method of taxation as much as it is about the amount of spending by the government. He reflects the views of the Libertarian party and most Libertarians.

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<sup>46</sup> <http://www.fairtax.org>

**=> Indirect Tax On Wages, Dividends, Interest, Etc.**

Although rarely discussed, one way to (1) simplify the tax system and (2) cut the number of tax brackets and (3) eliminate direct contact with taxpayers by the Federal government is to impose a tax on specific types of income at the level of the payor. We do this already with respect to dividends, royalties and real estate profits paid to foreign persons. The rate is different for different types of income, and the rates vary from country to country because of treaty agreements. But the tax is withheld by the U.S. person or company that is making the payment and the total of the withheld amounts are combined and sent to the IRS.

Within the U.S., a similar type of tax system could be easily implemented by having wages and payments to independent contractors subject to withholding. Payments of interest, dividends, rents, royalties and other forms of compensation could be subject to withholding. Those who are self-employed would have to pay some kind of gross profits tax or they could elect to file a return showing their net profits which would be subject to tax at a rate similar to wages or dividends. The corporate income tax should be dropped because it would represent a form of double taxation. For a variety of reasons beyond the purpose of this report, I would argue against a tax on capital gains from the sale of property or securities.

However, this type of tax system also fails to address the problem of restricting the amount of spending by the government and merely shifts the tax burden from one group to another. This system also tolerates a lot of tax avoidance by those who are able and willing to modify the form in which they receive income.

**=> Separate Taxing And Spending Authority**

As Charles Adams pointed out in "For Good and Evil", the English had a relatively stable system that kept taxes in check for hundreds of years. In their system, the Parliament was responsible for raising taxes while the Monarch was responsible for spending the money.

A similar system in the U.S. might involve having the Congress approve of all tax increases, while the Administration was responsible for deciding how the money was to be spent. Because the Congress could not provide direct or even indirect grants to their constituents, they would have no incentive to raise taxes any more than a bare minimum required for the national defense and other essential federal functions. In turn, the Administration would be limited to spending only the amounts that had been raised by the Congress.

However, this system would not necessarily prevent the Administration from using borrowed funds (as they do now) that are financed by foreign investors or

by new money printed by the Federal Reserve. And it would not necessarily eliminate the complexity of the income tax or the intrusiveness of the IRS.

### **=> Repeal The 16<sup>th</sup> Amendment And Prohibit Any Direct Tax**

Because the 16<sup>th</sup> Amendment to the Constitution was the justification for the establishment of an income tax by the Federal government, the only durable solution to the problem of the current income tax system is to first eliminate the power of the federal government to impose a direct or an unequal tax on the citizens of the U.S. states and territories. Until the 16<sup>th</sup> Amendment is repealed or altered to prevent a system of non-uniform and direct taxation, any other method of tax reform is at the pleasure and discretion of any future legislature. Whatever Congress can do, they can undo at any time. The current Congress cannot bind any future Congress by the mere passage of a law.

### **=> Voter Approval For Tax Increases**

An even more extreme change in the law than repeal of the 16<sup>th</sup> Amendment would be to require voter approval for tax increases in excess of a very modest annual adjustment to keep up with inflation. And if we included a Constitutional provision to prevent the ability of a central bank (the “Fed”) to create money by issuing notes to purchase federal bonds, then we would not need an annual adjustment for inflation. For a lot of information about the inflation tax and the role of the Federal Reserve in creating new money, see the Ludwig von Mises Institute web site <sup>47</sup> and the Ron Paul web site. <sup>48</sup>

### **=> Charles Adams Reform Proposals**

At the end of his study of taxation through history<sup>49</sup>, Charles Adams offers an assortment of specific proposals to prevent abuse of taxpayers by the IRS and to simplify the tax system. Here is a checklist of his suggestions, without being in any order of priority.

- Subject tax collectors to personal civil liability and criminal prosecution
- Have Federal Tax Districts equal to IRS Districts
- Provide voter recall of district directors of the IRS
- Treat tax disputes the same as any debt
- Decriminalize the tax law
- Immunize judges and congressmen from the IRS
- Prohibit taxes imposed directly on the taxpayer/citizen
- Adopt a maximum 10% tax rate and cut spending to = revenue

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<sup>47</sup> <http://www.mises.org>

<sup>48</sup> <http://www.ronpaul.com/>

<sup>49</sup> Charles Adams, *For Good and Evil: the Impact of Taxes on the Course of Civilization*, 1993, Madison Books

- Separate taxing and spending powers (Parliament and the king)
- Prohibit punitive fines and penalties

## Conclusion

Some readers may feel that the title of this report is an overstatement because U.S. citizens and residents still possess a great many freedoms as compared to a fascist or socialist totalitarian state. We are free to decide what kind of work we want to do, we can move freely from state to state, we can spend our money as we wish and we can exercise our right of free speech – to name only a few freedoms. Only a small percentage of people are audited by the IRS<sup>50</sup> and only a small percentage of those are convicted of a tax crime<sup>51</sup>.

How then can it be true that the income tax has destroyed liberty in the U.S.A. as the title of this report suggests?

The 16<sup>th</sup> Amendment to the Constitution gave the federal government carte blanche to confiscate as much of the earnings of any citizen or group of citizens as it chooses. In addition, the federal estate tax could confiscate nearly 100% of any after-tax property at the time of death, but the Congress chooses not to agitate the voters with such extreme taxation.

We had a 90% top income tax rate during the Second World War and a 70% top tax rate from the end of the war to 1981. Although these rates were confiscatory, the law was not as fine-tuned as it is today and there were a great many legal ways to avoid such a repressive tax rate. Until 1962, it was legal to use a foreign corporation to avoid taxes. Until 1976, it was legal to use a foreign trust to avoid taxes. And until 1986 it was legal to defer taxes with a foreign mutual fund.

But the use of any tax avoidance or tax deferral device is at the whim of the Congress and can be eliminated at any time. In the past 20 years, the Congress has been fine-tuning the tax laws to prohibit a great many previously legal ways to avoid or to defer income taxes. Unless the current law is extended, the estate tax exemption will return to \$1 million after 2010 and a liberal Congress could reduce it even further.

It is within the power of the Congress to confiscate all of the income and/or property of any single citizen or group of citizens at any time. Without property

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<sup>50</sup> The odds of an audit vary from year to year, but it has ranged from ½% to 1% of the taxpayers for the past few years.

<sup>51</sup> According to [Wikipedia](#), there were less than 100 tax protestor convictions in each of the past three years. No data is available regarding other tax crime convictions, but the total number of federal tax decisions was about 1% of the number of audits.

rights there is no genuine freedom. And after June 17, 2008, many citizens will not be able to leave the U.S. on a permanent basis without being subjected to a tax on any property they own anywhere in the world. At any time, the Congress could change that law to impose a tax on assets rather than on unrealized gains or tax deferred income. And they could impose a high rate of tax with a very low exemption – or even none.

That's the power the 16<sup>th</sup> Amendment has given our politicians.

What kind of emergency will cause a majority of U.S. voters to vote for a savior who promises to protect us from the emergency if we will only accept some unpleasant sacrifices until the emergency is over?

If the terrorists are able to get past our present defenses and bring their war to our shores, how many of us will object to the imposition of martial law for an open ended amount of time? And if our savior and commander-in-chief turns out to be a demagogue, what protection do we have?

The 16<sup>th</sup> Amendment to the Constitution has abolished property rights in the U.S. Without property rights, there are no other rights of any significance.

For those readers who are looking for an opinion about how to restore the liberties that have been lost, the only solution I regard as being durable is to repeal the 16<sup>th</sup> Amendment and to replace it with a new Amendment that is more strongly worded so that an income tax or any non-uniform and direct tax is explicitly prohibited. The Federal government would have to rely on customs duties, excise taxes, user fees and a national sales tax for essential revenue.

Of nearly equal importance is to find a way to prevent the government from inflating the money supply with new money issued by the Federal Reserve in exchange for new government debt obligations. In some respects, the inflation tax is far more insidious and destructive than the income tax. And it didn't require an amendment to the Constitution. It only required the establishment of a central bank with the authority to create paper money with nearly zero oversight by the Congress. But that's another subject for which there are commentators with a far greater understanding of the issues than I possess.

These are admittedly extreme solutions and it bothers me that the most popular tax reform plan (the "Fair Tax") doesn't require repeal of the 16<sup>th</sup> Amendment as a pre-condition to the imposition of a national sales tax. As I've explained in my newsletter<sup>52</sup>, I also don't agree with having a revenue neutral sales tax but I doubt that any kind of alternative would provide enough political support to become a serious contender for the income tax.

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<sup>52</sup> The International Wealth Protection Monitor ([www.offshorepress.com](http://www.offshorepress.com))

On a somewhat personal note, some readers may wonder why a tax accountant is in favor of eliminating the income tax. Surely it would be to my benefit to continue the income tax and to even benefit from additional complexity.

The only answer I can offer that I have had a strong Libertarian point of view since I first began to work. I was an avid reader of Ayn Rand's books during college and read a number of free market economic books as a way to get an alternative to the Keynesian economics that was the most widely accepted economic theory by college professors at that time. I majored in accounting and became a CPA as a practical career choice. I don't like having to engage in personal selling and didn't want to spend five years in an engineering program or seven years in the pursuit of a law degree. And those are the four occupations in which a college graduate can be productive very quickly and therefore can "earn his keep".

If all other things had been equal, I probably would have preferred a career in journalism. After 16 years of working as an accountant, I started a newsletter (about legal tax avoidance) and I've divided my time between working as a tax accountant for others and working as an independent financial journalist and book author.

I've been able to adapt over the years to do a lot of different things, including teaching, computer programming and financial planning. I have no fear of not being able to make a living if we could repeal the income tax.

But I do suspect that most of my professional colleagues think I'm nuts and I suspect my wife would agree with them.

Vernon Jacobs  
June, 2008

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## About the Author

Vernon Jacobs has more than 30 years experience working as a tax and financial consultant for investors and small business owners. He was an auditor with the “big four” CPA firm, Deloitte, Touche from 1962-1966. He served for five years as the chief accountant and then for seven years as the V.P./Controller of a mid-sized life insurance company, then for seven years as the editor of *Tax Angles* and for three years as the Consulting Editor for *The Journal of Accounting and EDP*. He has written hundreds of articles on taxes and financial topics and has been interviewed by dozens of national publications such as *The Wall Street Journal*, *Industry Week*, *USA Today*, *Forbes*, *Smart Money*, *Money*, *Bloomberg Personal Finance*, *Offshore Finance USA*, *Newsweek* and others.

He is the author or co-author of more than 25 books including *Offshore Tax Strategies* and the *Controlled Foreign Corporation Tax Guide*.

He is the author of *The Jacobs Report* and the *International Wealth Protection Monitor* newsletters and is a frequent seminar speaker.

### Professional Associations:

American Institute of CPAs  
International Tax Compliance Group  
Associate Member American Bar Association.

### Contact Information:

Vernon K. Jacobs, C.P.A., C.L.U., F.L.M.I.  
P.O. Box 8137, Prairie Village, KS 66208  
Phone & fax (913) 362-9667  
email: [jacobs1@kc.rr.com](mailto:jacobs1@kc.rr.com)  
<http://www.offshorepress.com/vkjcpa/>  
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