

Office of Chief Counsel
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Memorandum

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date: June 23, 2006

to: Western Area Manager
(Government Liaison & Disclosure)

from: Assistant Chief Counsel
(Disclosure & Privacy Law)

subject: Possible Exchange of Information Agreement with the City of Los Angeles Pursuant to I.R.C. § 6103(d)(1)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

Whether the City of Los Angeles, California's business tax is a "tax imposed on income or wages" within the meaning of I.R.C. § 6103(b)(5)(B) so as to allow the City of Los Angeles to receive returns and return information under I.R.C. § 6103(d)?

CONCLUSIONS

The City of Los Angeles's business tax is not a tax imposed on income or wages within the meaning of I.R.C. § 6103(b)(5)(B) and, therefore, the City of Los Angeles does not qualify for the disclosure of return or return information under I.R.C. § 6103(d).

FACTS

The City of Los Angeles, California (the "City") levies a business tax on every person engaged in the businesses or occupations enumerated in the City's Municipal Code. Los Angeles, Cal., Code ch. 2, art. 1 (2006). The business tax is a privilege tax paid for

the right to conduct business in the City. The amount of the tax varies by business or occupation, but is generally calculated based on a business's gross receipts. For example, a child care provider's business tax is \$23.65 per year, or fraction thereof, for the first \$20,000 or less in gross receipts, plus \$1.18 per year for each additional \$1,000 of gross receipts, or fraction thereof, in excess of \$20,000. Los Angeles, Cal. Code § 21.189.3. The City's municipal code defines gross receipts to include "the total amount received for all sales and commissions for the performance of any act, service or employment of whatever nature" with no deduction permitted for "the cost of the property sold, the cost of the materials used, labor, service costs interest paid or payable, losses, or any other expenses whatsoever." Los Angeles, Cal. Code § 21.00(a). Where the tax is based on other than gross receipts, the LA Code provides an alternative method of calculation. For example, billiard halls pay a tax of \$106.43 per year based on the number of tables owned. Los Angeles, Cal. Code § 21.62.

The City does not and cannot collect an income tax. California Revenue & Tax Code section 17041.5 specifically prohibits a municipality from collecting a tax on the income of any person. A municipality may, however, levy upon or collect a license tax from a person or business measured by its gross receipts. *Id.*, see *Weekes v. City of Oakland*, 579 P.2d 449 (Cal. 1978) (a license fee on employee's gross income was not a tax on income and, therefore, was not precluded by section 17041.5).

The City would like to enter an Exchange of Information Agreement with the IRS to allow it to receive return and return information pursuant to I.R.C. § 6103(d)(1). However, before the City can begin negotiating an agreement with the IRS, it must demonstrate that it meets the requirements of I.R.C. § 6103 (b)(5)(B). Our office has considered the City's qualifications as a state under I.R.C. § 6103(b)(5) on two earlier occasions, concluding in both instances that it failed to meet the statutory requirements. The City asked the IRS to reconsider the issue and has directed the IRS's attention to a definition of income tax found in Title 4 of the United States Code and as interpreted in *Howard v. Commissioners of the Sinking Fund of the City of Louisville, et al.*, 344 U.S. 624 (1953); neither of these were considered in our previous examinations of this issue.

LAW AND ANALYSIS

The IRS must protect the confidentiality of returns and return information unless disclosure is authorized by Title 26 of the Internal Revenue Code (the Code). I.R.C. § 6103(a). One exception to the general rule allows for disclosures to States for purposes of State tax administration. I.R.C. § 6103(d)(1). The exception allows the IRS to disclose tax information to State agencies charged under the laws of the State with responsibility for administration of State tax laws, but the tax information disclosed must relate to one or more of the enumerated chapters (e.g. chapter I – Normal Taxes and Surcharges, or chapter 6 – Consolidated Returns) and can only be disclosed to the extent the information is necessary for State tax administration. *Id.*

The definition of State, for purposes of section 6103, includes certain municipalities meeting the criteria set forth in I.R.C. § 6103(b)(5). To qualify as a State a municipality must (1) have a population of more than 250,000, (2) impose a tax on income or wages, and (3) sign an agreement with the IRS regarding the use and disclosure of the information provided. The City of Los Angeles, with a population of close to four million in 2003, clearly satisfies the population requirement. The crux of the issue is whether the City's business registration tax meets the second requirement under I.R.C. § 6103(b)(5)(B) that the municipality impose a tax on income or wages.

The City of Los Angeles would have the IRS interpret I.R.C. § 6103(b)(5)(B)(ii) by looking outside of the Code to 4 U.S.C. § 110(c). Section 110(c) of Title 4 of the U.S. Code defines income tax broadly to include "any tax levied on, with respect to, or measured by, net income, gross income, or gross receipts." Under this broad definition, the City's business registration tax, which is calculated on a business's gross receipts, satisfies the definition of income tax.

The definition of income tax found in 4 U.S.C. § 110(c) is part of the "Buck Act" (4 U.S.C. §§ 105-110) (the "Act"), enacted in 1940. In the Act, Congress authorized state and local governments to collect "income taxes" from individuals who work in a Federal area. 4 U.S.C. § 106(a). A Federal area is defined as "any lands or premises held or acquired by or for the use of the United States." 4 U.S.C. § 110(e). The Buck Act was passed for the limited purpose of "ensuring federal officers and employees who reside or work within exclusive federal enclaves would be treated equally with those who reside and work outside such areas." S. Rep. No. 76-1625, at 3 (1940).

The U.S. Supreme Court, in *Howard*, applied the definition of income tax in 4 U.S.C. § 110(c) to a business privilege tax imposed by the City of Louisville, Kentucky. *Howard v. Commissioners of the Sinking Fund of the City of Louisville, et al.*, 344 U.S. 624 (1953). Louisville imposed a license tax for the privilege of working within the city equal to 1% of the wages or salary earned within the city. *Id.* Employees working for the Navy on property owned by the Federal government challenged the city's authority to collect the tax from their wages or salaries, arguing that the Federal government had exclusive jurisdiction. *Id.* Based on its reading of the Buck Act, the Supreme Court found the Federal government had granted the state and local governments the authority to tax these employees as though the Federal government did not own the property where the jobs were performed. *Id.* at 627. The privilege tax, while not an income tax under state law, was an income tax for purposes of the Buck Act. *Id.* at 629; see also, *U.S. v. Lewisburg Area School District*, 539 F.3d 301 (3rd Cir. 1976) (school district's occupation tax met the definition of income tax and collection was permissible from employees of working on a federal enclave).

The legislative history for the Act clearly states that Congress intended income tax to be broadly defined as it

must of necessity cover a broad field because of the great variations to be found between the different State laws. The intent of your committee in laying down such a broad definition was to include therein any State tax (whether known as a corporate-franchise tax or business-privilege tax, or any other name) if it is levied on, with respect to, or measured by net income, gross income, or gross receipts.

S. Rep. No. 76-1625, at 5 (1940). Without such a broad definition, it would have been difficult to address the different types of taxes typically imposed by state and local governments. The Act, however, is a limited grant of authority to state and local governments and the definitions provided in 4 U.S.C. § 110 only apply to the Act itself.

There is no evidence to suggest Congress intended such a broad definition of income tax to apply to I.R.C. § 6103(b)(5) nor is it necessary to look beyond Title 26 for clarification. Section 6103(a) states that the confidentiality rules only yield if an exception is “authorized by this title.” I.R.C. § 6103(a). Given this limiting language in I.R.C. § 6103(a), it follows that the interpretation of the terms used within I.R.C. § 6103 should also be confined to Title 26.

There is sufficient guidance in Title 26 as to what constitutes a “tax on income or wages.” For federal income tax purposes, gross income is defined to include income from “whatever source derived,” but the tax is imposed on only “taxable income.” I.R.C. §§ 61, 63. Taxable income is gross income minus deductions as allowed by the Code. I.R.C. § 63. A distinction is made between these types of income because an income tax is a direct tax on gains or profits that falls on *net income*.

Fundamentally, there is a distinct difference between a tax on income and wages and a tax on gross receipts. Income is not the same as gross receipts; income is gain or profit remaining after accounting for costs. See *Allstate Insurance Co. v. United States*, 419 F.2d 409, 414 (Cl. Ct. 1969). Where a tax is imposed on gross receipts, the amount of the tax is unaffected by whether a taxpayer has a profit or loss for the tax year. The City’s business tax is based on gross receipts and, therefore, must be paid regardless of a taxpayer’s gain, profit, or loss.

Where deductions are allowed under the Code for taxes paid to state, local, or foreign governments, the deduction is dependent on the character of the tax. Section 164 allows for a deduction from gross income of state and local income taxes paid. I.R.C. § 164(a)(3). Similarly, section 901 provides a credit for “the amount of any income...taxes paid to any country.”¹ I.R.C. § 901(b). A foreign levy is an income tax qualifying for a credit under I.R.C. § 901(b) if the levy is a tax whose “predominant character” is “an income tax in the U.S. sense.” Treas. Reg. § 1.901-2(a). The regulations under section 901 articulate a three-part test to determine if the foreign levy qualifies for a deduction. To meet at least one prong of the test, a gross receipts tax will need to make some allowance for costs and expense to more closely mirror the concept of net income, otherwise a gross receipts tax will rarely qualify for a credit. Treas. Reg. § 1.901-2(b)(4).

The reference to a tax imposed on income and wages in section 6103(b)(5)(B) should be read consistently with the other provisions of Title 26. Under Title 26, a tax on income is a tax on net income. Because the City’s business tax is based on gross receipts with no allowance for costs and expense, the tax does not meet the requirements under I.R.C. § 6103(b)(5)(B) and, therefore, the IRS cannot disclose information to the City, at this time, under I.R.C. § 6103(d)(1).

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Please call _____ if you have any further questions.

¹ The language used in I.R.C. § 901 is nearly identical to that used in I.R.C. § 164.