

Ch 1 Lecture Notes

- 1) Who Cares About Taxes and Why?
 - a) Businesses
 - b) Politicians
 - c) Individuals
- 2) What Qualifies as a Tax?
 - a) Definition of a tax
 - i) Key components of definition: payment is required, imposed by a government agency, and not directly tied to any benefit received by the taxpayer from the government
 - b) Earmarked tax—definition and why this is considered a tax
 - c) Quiz students on tax definition using examples in the PowerPoint slides.
- 3) How to Calculate a Tax
 - a) $\text{Tax} = \text{Tax Base} \times \text{Tax Rate}$
 - i) Tax Base—what is actually taxed, usually expressed in monetary terms
 - ii) Tax Rate—level of taxes imposed on the tax base, usually expressed as a percentage
 - iii) Flat taxes
 - iv) Graduated taxes
 - v) Brackets
 - b) Different ways to measure tax rates
 - i) Marginal tax rate
 - (1) Definition—tax rate that applies to the next additional increment of a taxpayer's taxable income (or deductions)

$$(2) \text{ Formula — } \frac{\Delta \text{Tax}}{\Delta \text{Taxable Income}} = \frac{(\text{New Total Tax} - \text{Old Total Tax})}{(\text{New Taxable Income} - \text{Old Taxable Income})}$$

- (3) Useful in tax planning
- ii) Average tax rate
 - (1) Definition—a taxpayer's average level of taxation on each dollar of taxable income
$$\text{Formula — } \frac{\text{Total Tax}}{\text{Taxable Income}}$$
 - (2)
 - (3) Useful in budgeting tax expenses or comparing the relative tax burdens of taxpayers
- iii) Effective tax rate
 - (1) Definition—taxpayer's average rate of taxation on each dollar of total income, including taxable *and* nontaxable income
$$\text{Formula — } \frac{\text{Total Tax}}{\text{Taxable Income}}$$
 - (2)
 - (3) Provides the best depiction of a taxpayer's tax burden
 - iv) Work example in the PowerPoint slides calculating tax liability, marginal, average, and effective tax rates.
- c) Tax rate structures

- i) Proportional tax rate structure
 - (1) Definition—also known as a flat tax, imposes a constant tax rate throughout the tax base
 - (2) As the tax base increases, the taxes paid increase proportionally.
 - (3) The marginal tax rate remains constant and equals the average tax rate across the tax base.
 - (4) The most common example of a proportional tax is a sales tax.
 - ii) Progressive tax rate structure
 - (1) Definition—imposes an increasing marginal tax rate as the tax base increases.
 - (2) As the tax base increases, both the marginal tax rate and the taxes paid increase.
 - (3) Common examples of progressive tax rate structures include federal and state income taxes and federal estate and gift taxes.
 - iii) Regressive tax rate structure
 - (1) Definition—imposes a decreasing marginal tax rate as the tax base increases.
 - (2) As the tax base increases, the taxes paid increase, but the marginal tax rate decreases.
 - (3) Regressive tax rate structures are not common. In the United States, the Social Security tax and federal and state unemployment taxes employ a regressive tax rate structure.
 - iv) Discuss how different taxes can be viewed as having different rate structures when you consider effective tax rates versus marginal tax rates (e.g., the sales tax).
- 4) Types of Taxes
- a) Federal taxes
 - i) Income tax: Imposed on individuals, corporations, estates, and trusts. The largest federal tax.
 - ii) Employment taxes: Employment taxes consist of the OASDI tax (Social Security tax) and the MHI tax (Medicare tax). The tax base for these taxes is wages or salary and employers and employees split these taxes equally. Self-employed individuals must pay these taxes in their entirety.
 - iii) Unemployment taxes: Employers are also required to pay federal and state unemployment taxes, which fund temporary unemployment benefits for individuals terminated from their jobs without cause.
 - iv) Excise taxes: A tax based on quantity of goods or services purchased. Common examples include taxes on alcohol, diesel fuel, gasoline, and tobacco products and on services such as telephone use and air transportation.
 - v) Transfer taxes: The estate tax and gift taxes are based on the fair market values of wealth transfers upon death or by gift, respectively.
 - b) State and local taxes
 - i) Income tax: Most states impose an income tax. The calculation varies by state.
 - ii) Sales and use taxes: The tax base for a sales tax is the retail sales of goods and some services. Retailers collect and remit this tax. The tax base for the use tax is the retail price of goods owned, possessed, or consumed within a state that were *not* purchased within the state. The purpose of a use tax is to discourage taxpayers from buying goods out of state in order to avoid or minimize the sales tax in their home state.
 - iii) Property taxes: Assessed on the fair market value of real property and personal property. These are ad valorem taxes.
 - iv) Excise taxes
 - c) Implicit taxes
 - i) Indirect taxes that result from a tax advantage the government grants to certain transactions.
 - ii) Defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status.
 - iii) Difficult to quantify but important to understand in evaluating the relative tax burdens of tax-advantaged investments.
 - iv) Walk through examples of implicit taxes in text.
- 5) Evaluating Alternative Tax Systems

- a) Sufficiency
 - i) Involves assessing the aggregate size of the tax revenues that must be generated and making sure that the tax system provides these revenues.
 - ii) Static forecasting: Forecasting revenue ignores how taxpayers might alter their activities in response to a tax law change and to base projected tax revenues on the existing state of transactions.
 - iii) Dynamic forecasting: Forecasting that tries to predict possible responses by taxpayers to new tax laws.
 - iv) Income effect: As tax rates go up, people will work harder to maintain same after-tax income.
 - v) Substitution effect: As tax rates go up, people will substitute nontaxable activities because the marginal value of taxable ones has decreased.
 - vi) Equity: A tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay.
 - vii) Horizontal equity: Two taxpayers in similar situations pay the same tax.
 - viii) Vertical equity: Taxpayers with greater ability to pay tax pay more tax relative to taxpayers with a lesser ability to pay tax. Vertical equity can be viewed in terms of tax dollars paid or tax rates. Vertical equity may also be evaluated using effective tax rates instead of simply considering the tax rate structure.
 - ix) Certainty: Taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax.
- b) Convenience
 - i) A tax system should be designed to be collected without undue hardship to the taxpayer.
- c) Economy
 - i) A tax system should minimize the compliance and administration costs associated with the tax system.
 - ii) Can be viewed from the taxpayer's and government's perspective.
- d) Compare the income tax and sales tax using the equity, certainty, convenience, and economy criteria.
- e) Evaluating tax systems—the trade-off
 - i) Much of the debate regarding alternative tax systems reduces to a choice between simplicity and fairness.
 - ii) Those taxes that generally are simpler and easier to administer are typically viewed as less fair. Those taxes that may be viewed as more fair are often more complex to administer.

Ch 2 Lecture Notes

- 1) Taxpayer Filing Requirements
 - a) Filing requirements by entity
 - i) Individuals (show Exhibit 2-1)
 - ii) Corporations
 - b) Tax return due date and extensions
 - i) Individuals and C corporations
 - ii) Partnerships and S corporations
 - c) Statute of limitations
 - i) The period in which the taxpayer can file an amended tax return or the IRS can assess a tax deficiency for a specific tax year.
 - ii) Generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.
 - iii) A six-year statute of limitations applies to IRS assessments if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return.
 - iv) For fraudulent returns, or if the taxpayer fails to file a tax return, the statute of limitations remains open indefinitely.
- 2) IRS Audit Selection
 - a) Methods of selection
 - i) DIF system
 - ii) Document perfection
 - iii) Information matching
 - iv) Other methods
 - b) Types of audits
 - i) Correspondence examinations
 - ii) Office examinations
 - iii) Field examinations
 - c) After the audit (show Exhibit 2-2)
 - i) Proposed adjustment
 - ii) 30-day letter
 - iii) Appeals conference
 - iv) 90-day letter
 - v) Petition courts
 - vi) Trial-level courts and their differences: Tax Court, U.S. District Court, U.S. Court of Federal Claims
 - vii) Choosing a trial-level court (show Exhibit 2-3)
 - viii) Circuit Court of Appeals (show Exhibit 2-4)
 - ix) Supreme Court
- 3) Tax Law Sources
 - a) Primary and secondary sources
 - i) Primary tax authorities (show Exhibit 2-5)
 - ii) Secondary authorities (show Exhibit 2-6)
 - b) Legislative sources: Congress and the Constitution
 - i) U.S. Constitution

- ii) Internal Revenue Code
- iii) Legislative process for tax laws (show Exhibit 2-7)
- iv) Basic organization of the code (show Exhibit 2-8)
- v) Tax treaties
- c) Judicial sources: The courts
 - i) The hierarchy of the courts (trial level, appeals, Supreme Court)
 - ii) *Stare decisis*
 - iii) Golsen rule
- d) Administrative sources: The U.S. Treasury
 - i) Regulations: Three different forms (final, temporary, proposed); three different purposes (interpretative, procedural, legislative); highest administrative authority.
 - ii) Revenue Rulings and Revenue Procedures: More detailed than regulations; second in administrative weight. Definition of each.
 - iii) Letter rulings: Lower authoritative weight; contrast private letter rulings with determination letters and technical advice memorandums.
 - iv) Acquiescence, nonacquiescence, and actions on decision: Define and explain why important.
- 4) Tax Research
 - a) Understand facts
 - i) Open and closed facts
 - ii) How do you determine facts for a research question?
 - b) Identify issues
 - i) Ability to identify issues varies with experience.
 - ii) Understand facts, combine facts with understanding of law, identify general issues. (Is this income taxable? Is this expense deductible?)
 - iii) Research will allow you to identify more specific issues.
 - iv) Discuss Example 2-4 in class.
 - c) Locate relevant authorities
 - i) Annotated tax services: Definition and what they contain.
 - ii) Topical tax services: Definition and what they contain.
 - iii) How to use these services?
 - iv) Keyword search: Area of law and key facts; suggestions if key word searching is not proving beneficial.
 - v) Topical index
 - vi) Browsing the service
 - vii) Discuss Example 2-5.
 - d) Analyze tax authorities
 - i) Questions of fact: Hinges upon the facts and circumstances of the taxpayer's transaction. In this type of question, the researcher will focus on understanding how various facts affect the research answer and identifying authorities with fact patterns similar to her client's. For these types of research questions, judicial sources (court cases) will often specifically state this clearly and then focus their discussion on the facts and circumstances.
 - ii) Questions of law: Hinges upon the interpretation of the law, such as interpreting a particular phrase in a code section. If a researcher is faced with this type of question, they will spend much of their time researching the various interpretations of the code section and take note of which authorities interpret the code differently and why.

- iii) Identifying whether a research question is a question of fact or question of law is primarily helpful when there is some uncertainty in the application of tax law. Distinguishing between these two types of questions helps the tax researcher focus their efforts appropriately. For many tax questions, the answer is quite clear (e.g., the question is answered definitively in the Internal Revenue Code, Regulations, etc.). In these situations, there is no need to attempt to distinguish the question as a question of fact or question of law.
 - iv) Conflicting authorities: The tax researcher should evaluate the hierarchical level, jurisdiction, and age of the authorities, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer.
 - v) Checking the status of authorities: Citators and methods to check the status of authorities.
 - e) Communicate the results
 - i) The basic parts of a memo: Facts, issues, authorities, conclusion, and analysis.
 - ii) Facts: Discuss facts that provide necessary background of the transaction and those facts that may influence the research answer.
 - iii) Issues: State the specific issues that the memo addresses. Issues should be written as specifically as possible and be limited to one or two sentences per issue.
 - iv) Authorities: The researcher cites the relevant tax authorities that apply to the issue, such as the IRC, court cases, and revenue rulings. Cite enough to provide a clear understanding of the issue and interpretation of the law.
 - v) Conclusion: One conclusion per issue. Each conclusion should answer the question as briefly as possible, and preferably indicate why the answer is what it is.
 - vi) Analysis: The goal of the analysis is for the researcher to provide the reader a clear understanding of the area of law and specific authorities that apply. Typically an analysis will be organized to discuss the general area(s) of law first (the Code section) and then the specific authorities (court cases, revenue rulings) that apply to the research question. After you discuss the relevant authorities, apply the authorities to your client's transaction and explain how the authorities result in your conclusion.
 - vii) The basic parts of a client letter: Salutation and social graces, research question and limitations, facts, analysis, and closing.
- 5) Tax Professional Responsibilities
 - a) Tax professionals are subject to various statutes, rules, and codes of conduct.
 - i) AICPA Code of Professional Conduct
 - ii) AICPA Statement on Standards for Tax Services
 - iii) IRS's Circular 230
 - iv) State board of accountancy statutes
 - v) Common law
 - b) Failure to comply with statutes can result in being admonished, suspended, or barred from practicing.
- 6) Taxpayer and Tax Return Preparer Penalties
 - a) Civil penalties
 - i) Generally monetary penalties
 - ii) Imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause.
 - b) Criminal penalties
 - i) Much less common than civil penalties.
 - ii) Penalties are much higher and can include prison sentences.

- c) **Taxpayer** underpayment penalty: No underpayment penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return.
- d) A **tax return preparer** will not be subject to penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return.

Ch 3 Lecture Notes

7) Basic Tax Planning Overview

- a) Effective tax planning
 - i) Goal of tax planning: Maximizing the taxpayer's after-tax wealth while achieving the taxpayer's nontax goals.
 - ii) Three parties to every transaction: Taxpayer, other transacting party, and the government.
 - iii) Astute tax planning requires understanding the tax and nontax costs from the taxpayer's and other party's perspective.
 - iv) Three basic tax planning strategies: Timing, income shifting, and conversion.

8) Timing Strategies

- a) Timing
 - i) *When* income is taxed or expense is deducted affects the associated "real" tax costs or savings.
 - ii) The time when income is taxed or an expense is deducted affects the *present value* of the taxes paid on income or the tax savings on deductions.
 - iii) The tax costs of income and tax savings income vary as *tax rates* change. The tax costs on income are higher when tax rates are higher and lower when tax rates are lower. Likewise, the tax savings on deductions are higher when tax rates are higher and lower when tax rates are lower.
- b) Present value of money
 - i) \$1 today will be worth *more* than \$1 in the future.
 - ii) The implication of the time value of money for tax planning is that the timing of a cash inflow or a cash outflow affects the present value of the income or expense.
 - iii) When considering cash inflows, higher present values are preferred; when considering cash outflows, lower present values are preferred.
 - iv) $\text{Future Value} = \text{Present Value} \times (1 + r)^n$
 - v) $\text{Present Value} = \text{Future Value} / (1 + r)^n$
 - vi) Exhibit 3-1 provides discount rates for a single payment received in n periods using various rates of return.
 - vii) Work through Example 3-2.
- c) The timing strategy when tax rates are constant
 - i) Two basic tax-related timing strategies
 - ii) Accelerating deductions: Essentially accelerating a current cash inflow.
 - iii) Deferring income: Essentially deferring a current cash outflow.
 - iv) Work through Example 3-3.
- d) The timing strategy when tax rates change

- i) When tax rates are increasing, the taxpayer must calculate the optimal tax strategies for deductions and income. Why?
 - ii) The taxpayer must calculate whether the benefit of accelerating deductions outweighs the disadvantage of recognizing deductions in a *lower*-tax-rate year.
 - iii) The taxpayer must calculate whether the benefit of deferring income outweighs the disadvantage of recognizing income in a *higher*-tax-rate year.
 - iv) When tax rates are decreasing, taxpayers should accelerate tax deductions into earlier years and defer taxable income to later years. Why?
 - v) Accelerating deductions maximizes the present value of tax savings from deductions due to the acceleration of the deductions into *earlier* years with a *higher* tax rate.
 - vi) Deferring income minimizes the present value of taxes paid due to the deferral of the income to later years with a *lower* tax rate.
 - vii) Work through Example 3-5.
- e) Limitations to timing strategies
- i) (1) Tax deductions often cannot be accelerated without also accelerating the actual cash outflow that generates the deduction. (2) Tax law generally requires taxpayers to continue their investment to defer income. (3) A deferral strategy may not be optimal if the taxpayer has severe cash flow needs, if continuing the investment would generate a low rate of return compared to other investments, if the current investment would subject the taxpayer to unnecessary risk, and so on. (4) Constructive receipt doctrine: taxpayer must recognize income when it is actually or constructively received.

9) Income-Shifting Strategies

- a) Income shifting exploits the differences in tax rates across taxpayers by shifting income from high-tax-rate taxpayers (or jurisdictions) to low-tax-rate taxpayers (or jurisdictions) or shifting deductions from low-tax-rate taxpayers (or jurisdictions) to high-tax-rate taxpayers (or jurisdictions).
- b) Transactions between family members
 - i) Children generally have lower marginal tax rates, and therefore parents may shift income to children so it will be taxed at the child's tax rate.
 - ii) Assignment of income, IRS scrutiny of related-party transactions, and the kiddie tax limit this strategy.
- c) Transactions between owners and their businesses
 - i) Incorporating a business and thus shifting income from an individual to the corporation may result in lower current taxation of the business income. [See Example 3-8]
 - ii) Shifting income from a corporation to an owner through tax-deductible expenses (e.g., compensation, interest, rent) allows the owners to avoid double taxation on corporate profits.
 - iii) IRS scrutiny of related-party transactions limits this strategy.
- d) Income shifting across jurisdictions
 - i) Income earned in different jurisdictions—whether in the United States or abroad, and for state income tax purposes, income earned in different states—is often taxed very differently. With a proper understanding of the differences in tax laws across jurisdictions, taxpayers can use these differences to maximize their after-tax wealth.

- ii) IRS scrutiny of transfer pricing, implicit taxes, and negative publicity (e.g., for moving operations abroad) limits this strategy.

10) Conversion Strategies

- a) Tax rates can vary across different activities ; ordinary income is taxed at ordinary rates; long-term capital gains are taxed at preferential rates; some income is tax-exempt.
- b) The conversion strategy is based on the understanding that the tax law does not treat all types of income or deductions the same.
- c) To implement the conversion strategy, you must be aware of the underlying differences in tax treatment across various types of income, expenses, and activities and have some ability to alter the nature of the income or expense to receive the more advantageous tax treatment.
- d) Work through Example 3-10
- e) When the investment period is longer than one year, taxpayers can receive benefits from combining the timing strategy and the conversion strategy.
- f) Work through Example 3-11.
- g) Limitations of conversion strategies
 - i) The Code itself contains provisions to prevent a taxpayer from changing the nature of expenses and income.
 - ii) Implicit taxes may also reduce or eliminate the advantages of conversion strategies.

11) Additional Limitations to Tax Planning Strategies: Judicially Based Doctrines

- a) The IRS also has several other doctrines at its disposal for situations where it expects taxpayer abuse. These doctrines apply across a wide variety of transactions and planning strategies (timing, income shifting, and conversion).
- b) Business purpose doctrine: IRS has the power to disallow business expenses for transactions that don't have a business purpose.
- c) Step-transaction doctrine: IRS has the power to collapse a series of transactions into one to determine tax liability.
- d) Substance-over-form doctrine: IRS can reclassify a transaction according to its substance (instead of its form).
- e) Economic substance doctrine: Transactions must meet two criteria 1) the transaction must meaningfully change a taxpayer's economic position (excluding any federal income tax effects) and 2) the taxpayer must have a substantial purpose (other than tax avoidance) for engaging in the transaction.

12) Tax Avoidance versus Tax Evasion

- a) Tax avoidance is the legal act of arranging one's transactions to minimize taxes paid.
- b) Tax evasion is the willful attempt to defraud the government by not paying taxes legally owed.
- c) Tax evasion falls outside the confines of legal tax avoidance.