

Introduction to Income Tax Planning



Chapter 1

“Taxes are what we pay for a civilized society.”

– Justice Oliver Wendell Holmes

“There is no such thing as a good tax.”

– Sir Winston Churchill

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History of Taxation

▶ Before 1900, income taxes were used primarily to finance wars.

- **1861:** First Federal Income Tax Imposed
 - Repealed after the Civil War
- **1894:** Second Federal Income Tax Imposed
 - Supreme Court found the income tax was unconstitutional

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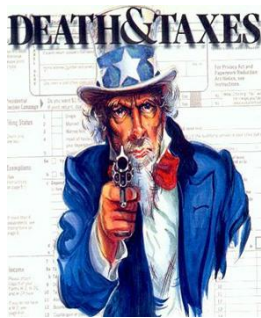
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Federal Income Taxes – A Timeline

- ▶ **Articles of Confederation** – no right to tax
- ▶ **U.S. Constitution** – taxing authority limited by apportionment clauses
 - 1894 Congress tried to impose an income tax
 - *Pollock v. Farmers' Loan and Trust Company (1895)*
 - Federal income tax was held to be unconstitutional
- ▶ Tax on corporations levied in 1909
- ▶ The 16th Amendment

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The 16th Amendment

- ▶ Adopted February 25, 1913
- ▶ “The Congress shall have the power to lay and collect taxes on *income, from whatever source derived*, without apportionment among the several States, and without regard to any census or enumeration.”

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The Revenue Act of 1913

- ▶ Income tax rates beginning at one percent and rising to seven percent for taxpayers with income in excess of \$500,000.
 - Less than one percent of the population was subject to the income tax.
- ▶ The Sales Pitch: Tax the Rich

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The 1913 Debate

A U.S. Senator opposed to the imposition of an income tax stated in debate:

“If they get away with 1% today, some day it may be raised to as high as 5%.”

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Have Things Changed ?

- ▶ Today:

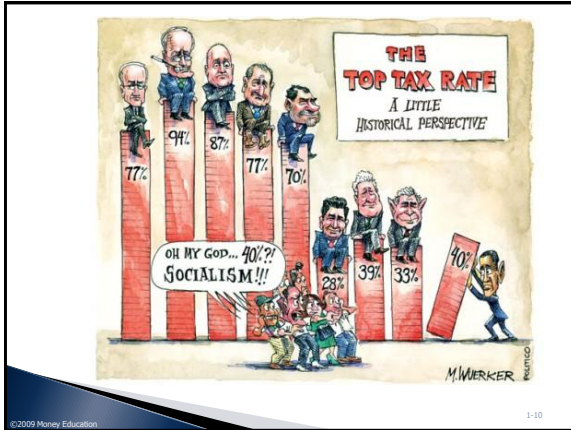
“I want to provide a tax cut for 95% of Americans. If you make less than a quarter of a million dollars a year, you will not see a single dime of your taxes go up. If you make \$200,000 a year or less, your taxes will go down..”

- Barack Obama, 2008 Presidential Campaign



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Functions of the Income Tax System

- ▶ Produce Revenue
- ▶ Management of the Economy
 - effectuate fiscal policy
 - encourage desired behavior
- ▶ Social Function
 - redistribution of wealth
- ▶ Regulatory Function
 - discourage undesirable activities

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Tax Structure

- ▶ **Tax Base:** amount to which tax rate is applied
- ▶ **Tax Rate:** applied to Tax Base to determine tax liability
 - Proportional
 - Progressive
 - Regressive
- ▶ **Incidence of Tax:** degree to which total tax burden is shared by taxpayers

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Types of Taxes

- ▶ Transaction (usually state tax)
- ▶ Estate and Gift
- ▶ Generation Skipping Transfer
- ▶ **Property (ad valorem)**
- ▶ **Income**
- ▶ **Employment**
- ▶ Other

Estate
Planning

Income
Tax

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U.S. Federal Tax System

3 Separate Tax Systems

Income Tax

Estate & Gift
Tax

Generation-
Skipping
Transfer
Tax

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Property (ad valorem) Taxes

- ▶ Based on asset value
- ▶ Assessed by state and local governments
 - Federal government is constitutionally prohibited from levying a property tax.
- ▶ Deductible for federal income tax purposes

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Federal Income Tax Formula

Income (broadly conceived)

Less: Exclusions

Gross Income

Less: Deductions for AGI

Adjusted Gross Income

Less: Itemized or Standard Deduction

Less: Personal and Dependency Exemptions

Taxable Income

Tax on Taxable Income

Less: Tax Credits

Tax Due (or Refund Due)



Employment Taxes

▶ FICA Taxes

- Paid by both employee and employer.
- In 2012, Social Security rate is 6.2% on a max of \$110,100 of wages beginning in March
- Medicare rate is 1.45% with no cap.

▶ Self-Employment Tax

- Rate is 15.3% (beginning in March).
- base is net self-employment income, and
- deduction (FOR AGI) is allowed for 1/2 of self-employment tax.

Number of Returns Filed

Type of Return	2009
Individual	144,103,000
Estate Tax	47,000
Gift Tax	245,000

Internal Revenue Collections

Type of Tax	Gross Collections* for 2009	Percent of 2008 Total
Individual Income Tax	\$1,190,382,757	50.8%
Employment Taxes	\$858,163,864	36.6%
Estate and Gift Taxes	\$24,677,322	1.1%

* Money amounts are in thousands of dollars.

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Basic Rules of Income Taxation

1. All accretions to wealth, from whatever source derived, constitute income
 - Exceptions:
 1. Realization Principle
 2. Capital Recovery Doctrine
 3. Public policy exclusions

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Basic Rules of Income Taxation

2. For every deduction taken, there must be an inclusion in income
 - Implications:
 - To claim a deduction on a tax return, that amount must have been included in income
 - Every deduction claimed by one taxpayer should constitute income to another taxpayer
 - Exceptions:
 - Qualified Retirement Plans
 - Charitable Planning

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Triads of Income Taxation

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- ▶ There are three (3)
 - Tax systems
 - Types of income
 - Types of tax accounting
 - Key tax principles
 - Components for classifying gain
 - Types of assets
 - Types of rental real estate
 - Methods of tax planning
 - Anti-abuse provisions
 - Administrative rulings
 - Final regulations
 - Courts to resolve disputes

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Overview of the Text

Chapter 2: Working with the Tax Law
Chapter 3: Fundamentals of Income Taxation
Chapter 4: Gross Income from Investment and Personal Activities
Chapter 5: Gross Income from Employment
Chapter 6: Introduction to Deductions
Chapter 7: Itemized Deductions
Chapter 8: Other Deductions, Penalties, and Loss Disallowance
Chapter 9: Tax Credits

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Overview of the Text

Chapter 10: Basis Rules, Depreciation, and Asset Categorization
Chapter 11: Capital Gains and Losses
Chapter 12: Business Assets
Chapter 13: Nontaxable Exchanges
Chapter 14: Passive Activity Rules
Chapter 15: The Alternative Minimum Tax
Chapter 16: Business Entity Selection and Taxation

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