Unit 01. Introduction to Taxation

The first chapter in PAK outlines the basic purposes and principles of taxation. This is an overview chapter. Read it with the goal of gaining a broad understanding of tax purposes and principles. Although the history is interesting, for our purposes, the sections on tax structure, types of tax, tax administration, and understating the tax law will be relatively more important.

For efficiency and space reasons textbook examples are not copied to the slides. Instead, you are asked to study specific examples in the textbook when you read through the slides at various points. These example-study notes are highlighted in RED.

Outline

- History of taxation in the United States
- Types of tax rate structures
- Other type of taxes
- Criteria for a tax structure
- Objectives of the federal income tax law
- Entities in the federal income tax system
- Tax law sources
- Enactment of tax law
- Administration of the tax law and tax practice issues
- Components of a tax practice

History of Taxation

Early Periods

- First federal income tax levied in 1861 to fund Civil war.
- It was repealed after the war.
- Federal income tax reinstated in 1894, but challenged in court. In 1895, Supreme Court ruled income tax unconstitutional!
- Constitution amended in 1913; 16th amendment gives Congress right to tax income.
  - ***The Congress shall have the 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.***

History of Taxation

Revenue Acts from 1913 to the Present

- Early tax rates were relatively low and high exemption levels effectively exempt most of the US population from paying taxes.
- In 1939, less than 6% of US population paid a federal income tax.
- Due to need for increased government revenue to fund World War II, tax base was broadened so that by 1945, 75% of the US population paid federal income tax.
- “Pay as go” withholding was added in 1943.

History of Taxation

Revenue Sources

History of Taxation

Revenue Sources

- Individual income taxes comprise almost ½ of the revenue received by the federal government.
- This share has held fairly steady over time.
- Social insurance taxes and contribution comprise about another third. This share has increased 18 percentage points since 1960.
- Corporate income taxes provide about 13% of government revenue. This share has decreased 10 percentage points sine 1960.

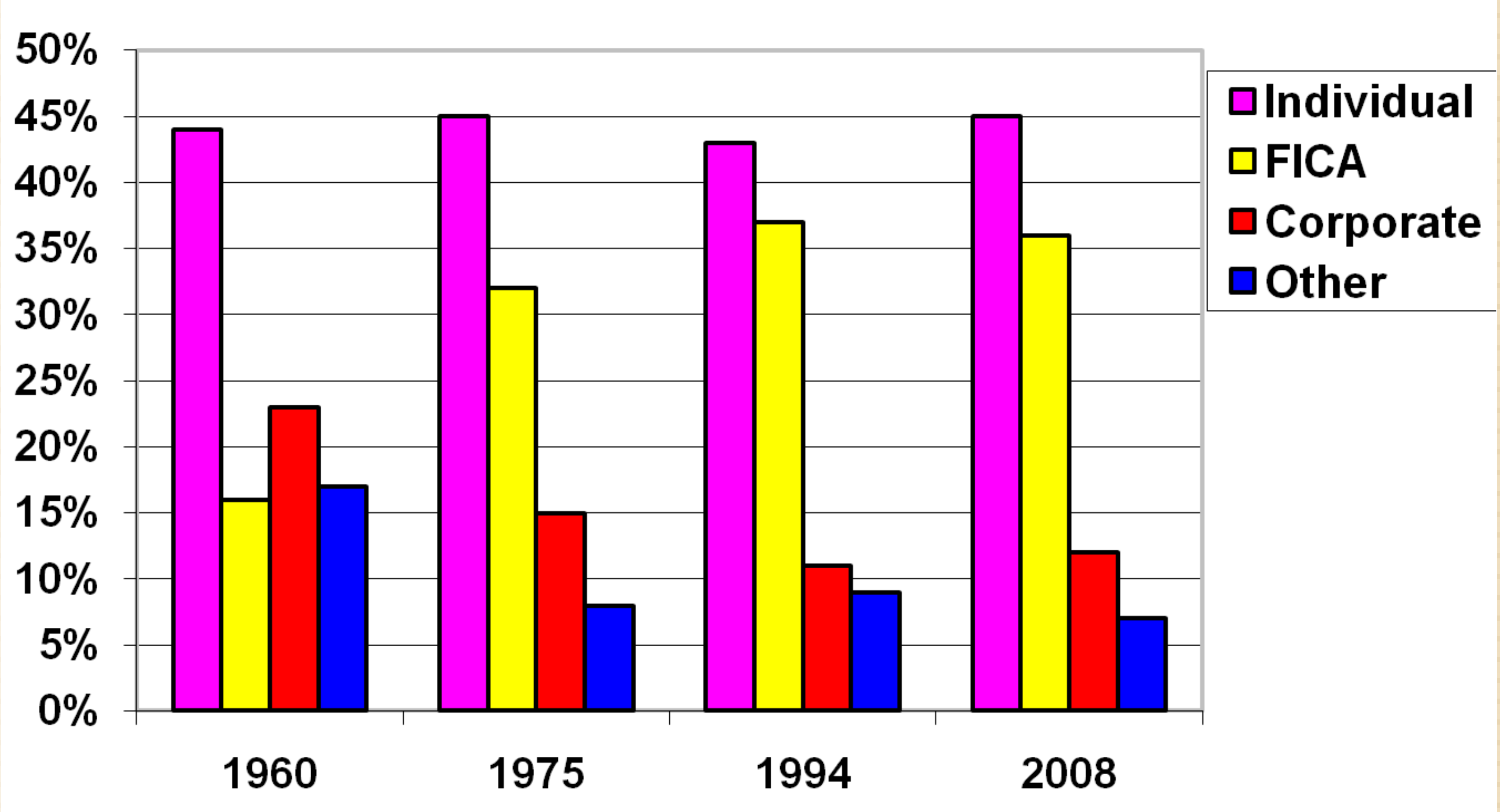


Figure 1.1. Breakdown of Federal Revenues: 1960-2008

Two Basic Components of Tax Structures

- Tax base:
  - The amount to which tax rate is applied to determine the tax due.
  - Example: taxable income
- Tax rate:
  - The percentage rate applied to the tax base

Types of Tax Rate Structures

Individual Income Tax Rates

- Possible tax rate structures are
  - Progressive: Rate increases as tax base increases, such as the current U.S. income tax.
    - Study Example1-1 and 1-2 on Page 1-4
  - Proportional (flat tax): Rate is the same regardless of tax base, such as sales tax
    - Study Example 1-3 on Page 1-4
  - Regressive: Rate decreases as tax base increases, such as the current U.S. FICA tax (Social security and Medicare tax)
    - Study self-study question on Page 1-5
- The current U.S. federal income tax system is mildly progressive (10%-35%).
- The benefits of personal and dependency exemptions are phased-out for upper-income taxpayers.
- Also, upper-income taxpayers will lose some benefit for certain itemized deductions.

Types of Tax Rate Structures

Individual Income Tax Rates for 2009

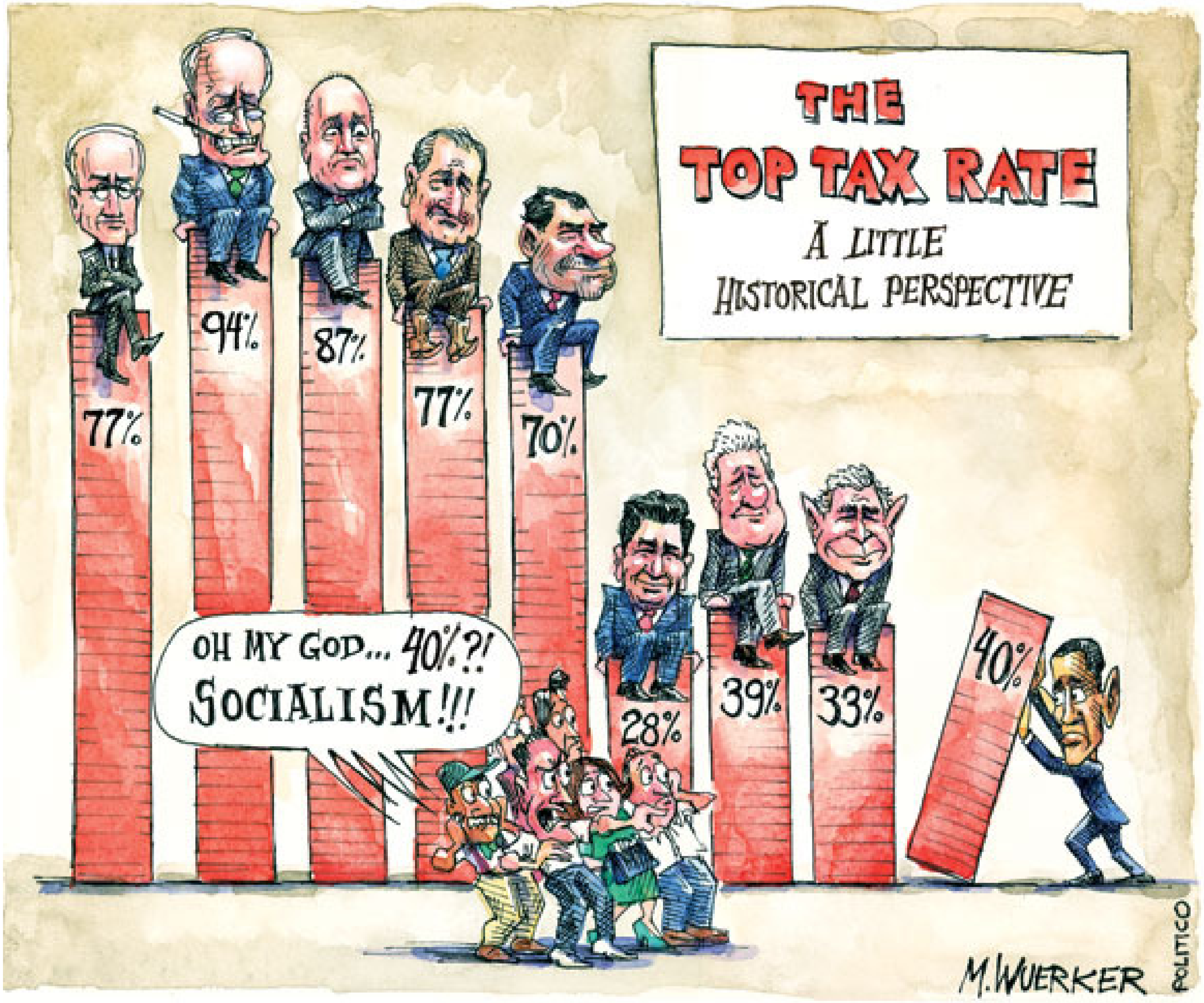
- For 2009 the federal income tax rate begins at 10% to increase to 15%, 25%, 28%, 33%, and 35%. For details see the inside front cover of the PAK textbook, or visit IRS website at http://www.irs.gov/pub/irs-pdf/i1040tt.pdf
- The two tables on the right show the tax rates for two filing statuses as examples.

Schedule X—If your filing status is Single

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$8,350	---------- 10%	$0
8,350	33,950	$835.00 + 15%	8,350
33,950	82,250	4,675.00 + 25%	33,950
82,250	171,550	16,750.00 + 28%	82,250
171,550	372,950	41,754.00 + 33%	171,550
372,950	--------	108,216.00 + 35%	372,950

Schedule Y-1—If your filing status is Married filing jointly or Qualifying widow(er)

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$16,700	---------- 10%	$0
16,700	67,900	$1,670.00 + 15%	16,700
67,900	137,050	9,350.00 + 25%	67,900
137,050	208,850	26,637.50 + 28%	137,050
208,850	372,950	46,741.50 + 33%	208,850
372,950	----------	100,894.50 + 35%	372,950


THE
TOP TAX RATE
A LITTLE
HISTORICAL PERSPECTIVE
77%
94%
87%
77%
70%
28%
39%
33%
40%
OH MY GOD... 40%?!
SOCIALISM!!!
M.WUERKER
POLITICO

Types of Tax Rate Structures

Corporate Tax Rates

- The tax rates for regular corporations (C corporations) are also mildly progressive (varying between 15% and 39%). A surcharge is applicable to high corporate taxable income.
- The stair-step pattern of progression tends to benefit small corporations
- Benefit of graduated tax rates phased out between $100K and $335K, and $15M and $18.33M

First $50K	15 % of Taxable Inc
> $50K But Not > $75K	$7,500 + 25% of Taxable Inc
> $75K But Not > $100K	13,750 + 34% of Taxable Inc > $75K
> $100K But Not > $335K	$22,250 + 39% of Taxable Inc > $100K
> $335K	34% of Taxable Inc
> $10M But Not > $15M	3.4M + 35% of Taxable Inc > $10M
> $15M But Not > $18,333,333	$5.150M + 38% > $15M
> $18,333,333	35% of Taxable Inc

Types of Tax Rate Structures

Marginal, Average, and Effective Tax Rates

- Marginal tax rate – most useful rate in tax planning
  - Tax rate applied to incremental amount of taxable income that is added to tax base.
  - Study Example 1-4 on Page 1-5
- Average tax rate
  - Total tax liability divided by amount of taxable income
  - Study Example 1-5 on Page 1-6
- Effective tax rate
  - Total tax liability divided by total economic income
  - Study Example 1-5 on Page 1-6
- The marginal, average, and effective tax rates may vary significantly from the nominal schedule rates.
  - For example, even though the nominal maximum individual rate is 35%, the marginal rate will be increased by any phase-out of exemptions or itemized deductions.

Types of Tax Rate Structures

Determination of Taxable Income and Tax Due

- Taxable income for all types of taxpayers is calculated by subtracting allowable exclusions, deductions, and exemptions from total income.
- The tax or refund due is calculated by subtracting allowable credits and/or prepayments from the gross tax liability resulting from applying applicable tax rates times taxable income.

Gross Income

- Deductions **for** AGI

= **AGI**

- Deductions **from** AGI

= Taxable Income

x Individual Tax Rate

= Gross Tax Due

- Credits & Payments

= Tax or Refund Due

Other Types of Taxes

- State and local income taxes
- State and local franchise taxes
- Wealth transfer taxes
  - Estate tax – Covered in FCS 5540 Estate Tax Planning
  - Gift tax: Tax imposed on the donor for transfer of property that is considered a taxable gift.
    - $13,000 annual exclusion per donee
    - Unlimited marital deduction for transfer between spouses
    - Charitable gifts are exempt – unlimited deduction
    - Study Example 1-6 on Page 1-8 and 1-9
- Other types of taxes
  - Property, excise, sales, & employment taxes

Criteria for a Tax Structure

How to judge whether a tax structure is "good"?

- Equity: How fair is the tax structure? Problem: Fairness is very subjective!
  - Vertical equity: Taxpayers who are not situated similarly should be treated differently.
  - Horizontal equity: Similarly situated taxpayers should be treated the same.
- Certainty
  - Stable source of government revenues
  - Amount of liability for taxpayers
- Convenience - Easily assessed, collected, and administered
- Economy
  - Minimal compliance and administration costs
  - Businesses spent $148B to comply with federal tax law and $80B to comply with state and local taxes
  - Cost to individuals $111B
- Simplicity - Should not be overly complex

Objectives of Federal Income Tax Law

- Economic Objectives:
  - Raise Revenues for Government Operations
  - Stimulate Private Investment
  - Reduce Unemployment
  - Mitigate Effects on Inflation
- Social Objectives:
  - Encouragement of certain activities and industries
    - Encourage corporate research activities by tax write-offs
    - Encourage charitable contributions (tax deductible)
      - Study Example 1-11 on Page 1-15
- Income tax reform proposals (Advisory Panel Report in 2005)
  - Simplified Income Tax Plan (SITP)
  - Growth and Investment Tax Plan (GITP)

Entities in Federal Income Tax System

Taxpaying Entities

- Various entities in the federal income tax system may be classified into two general categories: taxpaying entities and flow-through entities.
- Taxpaying entities: Directly pay income tax
  - Individuals
    - Taxable income = Total income – Exclusions – Deductions for AGI – Deductions from AGI
    - Study Example 1-13 on Page 1-18 to see how individual tax is computed
  - "C" corporations (regular corporations)
    - Taxable income = Total income – Exclusions – Deductions
    - Study Example 1-14 on Page 1-19 to see how a C corporation tax is calculated.
    - Double taxation on C Corporations
    - Study Example1-15 and Example 1-16 on Page 1-20 to understand the issue of double taxation on C corporations.

Entities in Federal Income Tax System

Flow-Through Entities

- Flow-through entities: Do no directly pay income tax
  - Sole proprietorship (Also known as a Schedule C business).
    - Business income earned by the proprietor is reported on Schedule C of his/her individual income return.
  - Partnerships
    - Study Example1-17 and Example -18 on Page 1-21
  - S Corporations
    - Study Example 1-19 and Example 1-20 on Page 1-22
  - LLC (Limited Liability Company)
    - Study Example 1-21 on Page 1-23
  - LLP (Limited Liability Partnership)
    - Study Example 1-22 on Page 1-23
  - Trusts and estates to the extent the trust's or estate's income is distributed (Example I: 1-23)

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Entities in Federal Income Tax System

Other Entities

- Trusts and estates – hybrid entities
  - If income is not distributed then they are taxpaying entities
  - To the extent the trust's or estate's income is distributed they are flow-through entities
  - Study Example 1-23 on Page 1-23

Tax Law Sources

- Legislative tax law sources include
  - Internal Revenue Code
  - Congressional Committee reports
- Executive (administrative) tax law sources include
  - Income tax regulations
  - Revenue Rulings
  - Revenue Procedures
  - Private Letter Rulings
- Judicial tax law sources include various levels of court decisions
  - Trial courts: District Court, Tax Court, U.S. Court of Federal Claims
  - Appeals courts: Circuit Courts
  - Supreme Court

Enactment of a Tax Law

- The procedures for enactment of tax legislation are the same as those for any other federal legislation, with the exception that all revenue measures are constitutionally required to be introduced in the House of Representatives.
- These procedures include deliberations by the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee.
  - The committee reports produced during these deliberations are valuable sources of legislative intent used in governmental and taxpayer interpretation of the enacted legislation.
- The political process affects tax legislation as it proceeds through the House of Representatives and the Senate towards the President's signature. The economic, social, and revenue priorities of the legislators (and their constituencies) affect the final product. Also, efforts to reduce the budget deficit in recent years have had an impact on annual tax legislation.

Enactment of a Tax Law

Steps

1. House of Representatives responsible for initiating new tax legislation
   - President may make proposal to Congress with studies on needed tax reform prepared by Treasury
2. Referred to the House Ways and Means Committee (HW&MC)
3. Voted on by HW&MC
   - Forwarded to House of Representatives for a vote if approved by HW&MC
4. Voted on by House of Reps
   - If approved, sent to Senate Finance Committee (SFC)
5. Voted on by SFC
   - If approved, sent to Senate for a vote
   - Bill may be different than House version

Enactment of a Tax Law

Steps Continued

6. Senate considers bill and may add amendments
7. Voted on by Senate
   - If approved, sent to Joint Conference Committee (JCC) to reconcile bill
8. JCC produces final bill
   - Sent back to House and Senate to vote on final bill
9. If JCC bill approved, sent to President for approval or veto
10. Presidential veto may be overturned by 2/3 vote in both House & Senate
11. Committee reports prepared by staff of HW&MC, SFC, and JCC

Administration of the Tax Law & Tax Practice

Organization of the IRS

- Important personnel in the IRS (in descending authority) are
  - The Commissioner of the Internal Revenue
  - Deputy and assistant commissioners
  - Regional commissioners
  - District directors
- Tax litigation in Tax Court is handled by the office of the Chief Counsel.
- Tax litigation in a U.S. District Court and the U.S. Claims Court is handled by attorneys in the Department of Justice.

Administration of the Tax Law and Tax Practice
Enforcement procedures

- The U.S. tax system is based on self assessment & voluntary compliance. However, enforcement by the IRS is essential to maintain the integrity of the tax system.
- With the use of computer analysis and professional judgment, taxpayer returns are selected for additional correspondence, office audit, or field audit.
  - Mathematical errors and certain matching problems (i.e. the amount of interest on a form 1099 received by the IRS does not match the amount of interest reported by the taxpayer) can generally be resolved by correspondence.
    - Study Example 1-24 on Page 1-27.
  - In an office audit, the taxpayer is asked to bring documentation to the IRS office to substantiate income, deduction, and/or credit items on the taxpayer's return.
    - Study Example 1-25 on Page 1-27
  - More complex audits are handled by a field audit where the IRS agent goes to the taxpayer's place of business or to the office of the taxpayer's tax professional.

Administration of the Tax Law and Tax Practice
Selection of Returns for Audit

Administration of the Tax Law and Tax Practice
Selection of Returns for Audit

- The IRS uses both computers and experienced personnel to select returns for examination.
  - Computer: Discriminant Function System (DIF)
    - DIF system generates "score" for return based on the potential for the return to generate additional tax revenue
  - Returns manually screened by IRS
    - Decide which returns to examine further based on experience
  - Less than 1% of all individual returns are selected for examination each year
    - While the overall individual audit rate is less than 1%, individuals with relatively large amounts of income and deductions are significantly more likely to be audited. If a return contains a frequently disputed item (i.e. home office deduction), the likelihood of audit also increases.

Administration of the Tax Law and Tax Practice

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Administration of the Tax Law and Tax Practice Issues - Statute of limitations

"We were going over some of your returns from a past life and..."

Administration of the Tax Law and Tax Practice

Statute of limitations

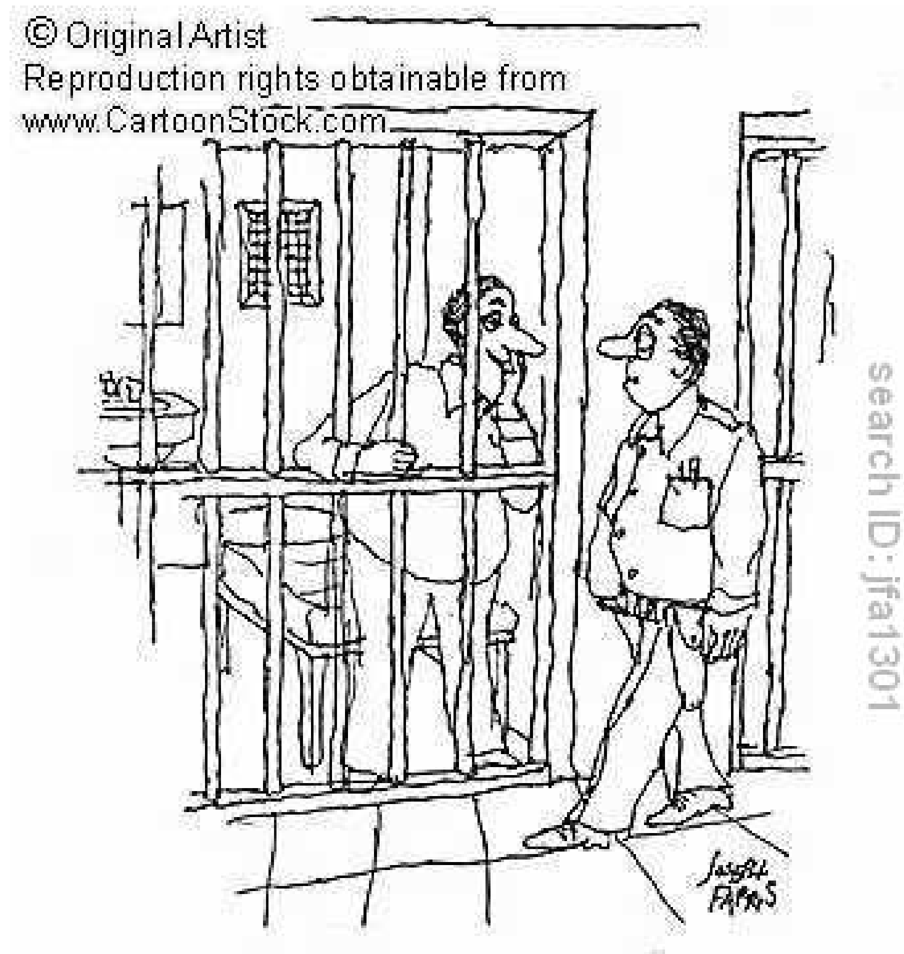
- General rule 3 years from later of the date tax return was actually filed or due date
- Six years if taxpayer omits items of gross income that in total exceed 25%
- Indefinite if fraudulent return filed or no return filed
- The applicable statute of limitations may be extended by mutual agreement between the taxpayer and the government. Reticent taxpayers are encouraged to extend the statute of limitations when the alternative is an immediate unfavorable notice of deficiency. These varying lengths of statutes of limitation can cause a record keeping problem for taxpayers.
- Study Example 1-26 on Page 1-28

Administration of the Tax Law and Tax Practice
Interest and Penalties

- If IRS owes you a refund
  - The IRS has 45 days to issue a refund without paying any interest.
- Interest and penalties may apply to tax due and other taxpayer noncompliance.
  - Penalties are not tax deductible. Here are some examples of these panalties:
    - A penalty of 5% per month subject to a 25% maximum for failure to file a tax return.
    - A penalty of 0.5% per month up to a 25% maximum for failure to pay the tax that is due.
    - A 75% penalty for fraud.
    - A penalty based on current interest rate for underpayment of estimated taxes.

Administration of the Tax Law and Tax Practice
Administrative appeal procedures

- Disputes between IRS agents and taxpayers may be resolved with the IRS Appeals Division.



"Psst! Would you like an expert to fudge your income tax returns?"

Addition Things to Study

- Answers to Selected Textbook Problems:
  - 1-4, 1-5, 1-8, 1-19, 1-26, 1-42, 1-45, 1-46, 1-48, 1-49
  - http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit01.pdf
- Self-study Quizzes on Publisher's website:
  - http://wps.prenhall.com/bp_pope_fedtax_2010/120/30826/7891613.cw/index.html
- Homework Assignment for Unit01 (Graded)
  - PAK, Chapter 1 Problems: 1-39, 1-40, 1-41, 1-43, 1-44, 1-47.
  - Please go to the "Learning Modules" link on Blackboard/WebCT to submit your assignment. You can also access it directly through the "Assignments" link.
- Discussion Topic for Unit01(Graded)
  - Don't forget to post your thoughts on the discussion topic of the week.
  - Go to the "Learning Modules" link on Blackboard/WebCT to post your thoughts. You can also access it directly through the "Discussions" link.