

FEDERAL INCOME TAXATION



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Introduction to Federal Taxation

A law school subject, but much more:

- 1) Black letter law.**
- 2) Relevance to subject matter of most other law school courses.**
- 3) Income tax fundamentals - whom to tax; what to tax; when to tax; how to tax.**
- 4) Social policy, i.e., tax burden distribution.**
- 5) Economic policy (macro & micro).**

Federal Income Tax is a Statutory Course p.24

1) **Primary source of law - The Internal Revenue Code (Title 26 of the United States Code) (assuming authority under the United States Constitution).**

See Code §§1 and 11 – the tax imposing provisions.

2) **Administration of tax system by the Internal Revenue Service (part of U.S. Treasury Dept.); Regulations and other pronouncements. P. 24-25**

3) **Resolution of disputes by the U.S. Courts including the U.S. Tax Court (an Article 1, not Article 3, court). P. 19-20.**

Constitutional History of U.S. Income Taxation p.22

U.S. Constitution - Art.1, Sec. 8, Cl. 1: Congress shall have the power to lay and collect taxes; subject to the uniformity clause. P.22

**Art. 1, Sec. 9, Cl. 4: No capitation or other direct tax shall be laid unless in proportion to the census.
What is a “direct” tax? P. 23**

continued

U.S. Constitution, cont.

p.23

- **Fifth Amendment** – no deprivation of property without due process of law.
- **Tenth Amendment** – states’ rights, except where the power is granted to the Federal Government.
- **16th Amendment** – tax can be imposed on “*income from whatever source derived*” (e.g., are emotional distress damages to be treated as “income” – under the U.S. Constitution?)

Federal Taxes – History

Before the 16th Amendment

1894 - personal income tax was enacted.

Supreme Court holds: Unconstitutionally imposed tax - Pollock v. Farmers Loan & Trust (1895), p.23
a tax imposed on unapportioned real property
rental income was deemed a tax on property and tax
was not apportioned (by population); therefore, this
tax was an unconstitutional tax (Art 1, § 9).

Subsequent History of U.S. Taxation - 1913

U.S. Constitution - 16th Amendment (p.23):
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.
Thereafter: enactment of the Revenue Act of 1913, and all subsequent legislation (for 100+ years).

CURRENT OTHER TYPES OF TAXES

- 1) **Poll tax (head tax); the simplest tax?; cf., ID requirements at the polls (e.g., in Texas).**
- 2) **Customs duties (inbound goods, e.g., tea).**
- 3) **Excise duties (transaction taxes, e.g., sales)**
- 4) **Property/wealth taxes (ownership taxes).**
- 5) **Wage taxes (tax on labor income).**
- 6) **Gains derived from capital or trading profits (income taxes on investments).**

Payroll Taxes

p.3

Social security taxes and Medicare taxes - Employer and employee portions: 6.20% each on OASDI wage base (\$128,400 during 2018 or \$7,960.80). Tax withholding at source. For self-employed: S.S. tax @ 2.40% (\$15,921.60). Plus Medicare tax: 1.45% for both employer & employee portion; no ceiling on the Medicare tax. Note: 2/3rds of households pay more in Social Security taxes than in federal income tax.

Taxation of International (i.e., Cross-border) Income

How define federal govt.’s “jurisdiction to tax”?

See Code §1.

Worldwide applicability of the U.S. income tax – to both U.S. individuals and U.S. corporations.

Why do U.S. corporations expatriate?

U.S. tax on foreign source income subject to:

- 1) Modification by U.S. income tax treaty.**
- 2) Foreign tax credit (for foreign tax paid).**

VALUE ADDED TAX

Most Common Tax in World

National sales tax, but imposed on a staged basis, i.e., on the “value added” at each level of production.

Tax on total value of the sale, less a refund to the seller for prior tax paid on the item being sold.

Cf., state sales tax - imposed only on the final sale.

VAT as an excise tax (i.e., a “transactions tax”).

Consider the regressive nature of this tax?

Federal Tax Revenue as a % of GDP

See chart p.7

What is GDP (gross domestic product)?

**Federal income taxes are imposed at
approximately the 10 percent level of GDP.**

Total federal taxes = 18 percent of GDP.

What is the relevance of this percentage?

Cf., GDP percentage in other countries.

Cf., GDP to national debt – what %?

Sources of Federal Revenue

GDP

What percentages of contributions to the total federal revenue? P.6

Individual income tax

Payroll taxes (income taxes, withheld at source)

Corporate income tax – why % decline?

Excise taxes (alcohol, tobacco, gas, etc.)

Estate & gift taxes (each is a “transfer tax”)

COMPARATIVE TAX BURDENS

On a comparative basis are U.S. taxpayers subject to a high tax rate? Low tax rate? (when compared to total taxes imposed by other national governments)

What is the difference between (see p.1 & p.31):

- 1) the effective rate, and**
 - 2) the marginal rate?**
- Cf., nominal tax rate.**

Distributional Effects p.12

Do the rich pay more (or less) proportionately?

Does U.S. have a progressive tax/regressive tax?

(cf., taxes imposed on dividends, cap. gains & a “carried interest”)

Should the rich pay more proportionately (because of their “ability to pay”)? P.12

Even if paying more proportionately, are the “rich getting richer and the poor getting poorer”? Is this important for purposes of “federal tax policy”?

What degree of progressivity is appropriate? P.12

Flat tax vs. progressive tax and, if progressive, what degree of progressivity?

Should progressivity be dependent upon the receipt of governmental benefits? See the “Gini” index – measuring the public service benefit to each taxpayer.

What is tax regressivity? Why not make the poor contribute proportionately more (assuming they are a “drag” on the economy)?

Income Tax Terminology p.26

What is the "Tax Base"?

Gross income – defined, see Code §61(a):

- Including wages, property gains, and many other types of “accessions to wealth.”

- Property gain necessitates identifying proceeds above cost or “tax basis.” (p.28).

Less: Deductions – (a) “above the line” (i.e., expenses for generating the income?), including depreciation and amortization, and

(b) “below the line.” p.26

Income Tax Terminology, Cont.

Tax rates are applied to taxable income.

cf., the average rate & the marginal rate – p.32

Tax accounting/timing issues (i.e. deferral):

p. 30 – “a penny saved is a penny earned”

(B. Franklin) or “*time value of money*” p.254.

Credits offset the tentative income tax

liability: cf., (1) refundable vs. (2) nonrefundable

credits. E.g., EITC (p.2) & withholding.

Why Impose Tax on "Income"?

P.12

Tax (1) income (receipts), (2) consumption (rewarding savings), or (3) wealth (ownership)?

How evaluate these taxes, including the income tax: (1) equity, (2) efficiency and (3) simplicity.

Consider the concept of "distributive tax justice."

Horizontal vs. vertical equity. P.12

Why progressivity? Ability to pay? Other reasons?

What degree of progressivity is appropriate?

Basic Income Tax Principles

“Personal income” as a federal income tax concept.

Other possible income measurement systems:

- **Trust accounting – purpose (P&I)?**
- **Financial accounting/GAAP – purpose?**
- **Economic income (i.e., net worth)**

Haig-Simons *definition* of “income” – p.554

- **1) market value of one’s consumption, and**
- **2) the change in value of one’s property rights.**

Measurement of net wealth changes

Changes in net wealth (“accretion to wealth”):

increases in savings and investment

less: debts and liabilities

Timing for tax: Measurement of changes in wealth on a “transactional” basis, not on an economic basis (even though an accrual of economic value may occur over several tax/calendar years).

A “realization” event is required (but, this is not a U.S. constitutional requirement). See discussion of “realization” (vs. recognition) at p. 28.

Tax Expenditure Budget

p.27 (& see web materials)

What is a “tax expenditure”?

- deviations from the norm for the measurement of economic income (both positive and negative amounts).

What is the “tax expenditure budget”?

What is the starting point for measuring the deviation from true economic income?

Are these expenditures actually appropriations without the Congressional budget process?

What is “dynamic scoring”? Appropriate to use?

Tax Expenditures, cont.



Tax Subsidies vs. “Tax-Induced Structural Distortions”

Tax subsidies:

- Tax transfers, e.g., refundable credits**
- Social spending, e.g., charitable deduction**

What are “upside-down” subsidies?

Tax Expenditures, cont.

Other reallocation mechanisms:

- **Energy credits**
- **First time home buyer's credit**

Non-tax system allocations:

“Cash for clunkers” – U.S. Govt. rebates

TARP – banking system recovery (loans or investments?)

The Tax Legislative Process

U.S. Constitution, Article 1, §7, Clause 1 - Tax legislation starts in the U.S. House of Representatives (Ways & Means Comm.). Why?

Note: Tax origination clause.

Then: U.S. Senate (Senate Finance Committee).

What if a large amendment occurs on Senate side?

Conference Committee; then enactment.

Last: Signed into law by the U.S. President.

(What is the “budget reconciliation” process?).

Federal Tax Legislation

p.29



Internal Revenue Code of 1986, as amended
Revenue Reconciliation Act of 1993 - 39.6% tax
Small Business Job Protection Act of 1996
Taxpayer Relief Act of 1997
**Economic Growth and Tax Relief Reconciliation Act
of 2001 (P.L. 107-16)**
**2004 Jobs Act; then 110 more tax acts; then the
American Taxpayer Relief Act of 2012 (or 2013?).**
Tax Cuts & Jobs Act (TCJA), 115th Cong.;12-27-17.

Statutory Interpretation

What is the Process? P.24

Relevance of tax legislation history (Committee Reports and the JCT “Bluebook”)?

U.S. Treasury Department “regulations”

- Interpretative; Legislative**
- Temporary and Proposed Regs.**

§7805(e) re “sunset” of Temp. Regulations.

What is relevance of the Federal Administrative Procedure Act (APA)? Recent Altera case (2015).

Is the IRS a “federal agency” for purpose of APA?

Responsibilities of IRS

p.16



Mandate of the Internal Revenue Service (an agency of the U.S. Treasury Department):

- Interpretation of the tax statutes and implementation of (1) interpretive (explanatory) regulations, and (2) legislative regulations (subject to APA requirements).**
- Enforcement, including tax reporting, tax collection, and litigation.**

What “Deference” to be Paid to Treas. Regulation? p.24,fn

Is an IRS regulation entitled to “deference”?

What is deference? See Chevron (not a tax case); cf., National Muffler.

What is the degree of authority granted to the IRS in promulgating a regulation?

Can an agency speak with the “authority of law”?

Can a Treasury Regulation be held invalid?

IRS Interpretations of Tax Law

p.25

Acquiescence by IRS to Tax Court decisions

IRS Revenue Rulings (Rev. Rul.)

IRS Revenue Procedures (Rev. Proc.)

IRS Notices

IRS Private Letter Rulings (PLRs)

Technical Advice Memoranda (TAM)

Chief Counsel Advice (CCA)

Closing Agreements

IRS Determination Letters

Tax Return Filing p.17

Self-assessment system is imposed for all taxpayers; cf., penalties? But, subject to tax withholding at source on wages & outbound (from U.S.) payments.

Review of income tax returns – quite limited review; cf., other countries. Tax return audit process – correspondence; office audit; & field audit.

Does a “tax collection gap” exist?

Ethics of engaging in the “audit lottery”?

What is Dispute Resolution Process with IRS? p.17

IRS review of income tax returns –

(1) computer matching; (2) office audit; & (3) “field audit.”

Administrative appeals process.

Statute of limitations – three or six years?

No running of statute of limitations if (1) no return is filed or (2) a fraudulent return is filed.

What potential impact of tax penalties?

What level of delinquency for a penalty?

Freedom of Information Act (FOIA)

What amount of disclosure is required?

**Limited disclosure of tax return information –
Section 6103.**

**Disclosure of private letter ruling information? Yes,
but crucial information is to be excised before
release.**

**Note: 2013 FOIA filing by Tax Analysts re the
501(c)(4) (issue re tax exemption status for certain
organizations).**

Tax Litigation - Judicial Review -

U.S. Tax Court petition after a “90 day letter” is received from IRS (no payment required). P. 19

Tax refund litigation:

U.S. District Court (a suit against the U.S.)

U.S. Court of Federal Claims.

What “forum shopping” opportunities?

Appeal to a U.S. Court of Appeals P.20.

What if a “split” in the Federal Circuits?

What is the impact of the “Golsen” case? P.20.

U.S. Sup. Ct. is final arbiter (e.g., re Obamacare).

Possible Injunction Against Tax Imposition?

Anti-injunction act precludes prior restraint of collection of taxes.

Bob Jones University (p. 638) – the federal “anti-injunction act” barred an action to enjoin the IRS from withdrawing a tax-exempt status ruling letter.

What “standing” to sue is required in challenging a tax statute?

Or, particularly, concerning an IRS decision to not collect tax from a “taxpayer”?

TIME VALUE OF MONEY p.254

Pay Tax Today or Tomorrow?

Tax planning objective is deferral: (1) Delay income & (2) accelerate deductions.

What is the importance of the “time value of money” concept?

Note the compound interest analysis:

cf., simple interest vs. compound interest.

How often should compounding of value accretion occur: Yearly, monthly, daily?

TIME VALUE OF MONEY



Present Value Analysis: funds which are only available in the future are worth less than funds which are available today.

What is the present economic value of \$x amount to be received ten years from today?

What is the relevance of the current market rate of interest? What is this “market”?

Asset Valuation and Financial Analysis

The fair market value of an asset is the sum of the present values of all future yields on the particular asset.

These “yields” can include interest, dividends, rents, gains, sales proceeds & liquidation proceeds.

What if the stated interest rate does not equal the market interest rate? The “face value” and the “market value” of the instrument are different.

Examples



How does this “time value of money” concept relate to the payment of federal income taxes?

Options:

- 1) Pay the tax today.**
- 2) Defer tax payment for five years (no interest).**
- 3) Pay a 10% (?) per annum compounded interest charge to IRS on a delayed tax payment.**

What is the advisory role of tax lawyers in helping to achieve deferral of income tax payment?

Opinion Practice & Tax Advice



What is the function of the “tax advisor” (as contrasted with the “tax litigator”)?

What is a “tax opinion”? What is its purpose?

What are the responsibilities of the advisor in issuing the tax opinion?

What are the professional practice risks in this context?