Chapter 1

An Introduction to Taxation and Understanding the Federal Tax Law

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History of Taxation (slide 1 of 2)

- Prior to 1900s income tax financed wars
  - 1861: First Federal individual income tax enacted
    - Repealed after Civil War
  - 1894: New Federal individual income tax enacted
    - Tax found to be unconstitutional

History of Taxation (slide 2 of 2)

- Other important events
  - 1909: First Federal corporate income tax enacted
  - 1913: 16th Amendment ratified
    - Sanctioned both Federal individual and corporate income taxes

Criteria for Evaluating a Tax Structure (slide 1 of 2)

- Adam Smith identified the following criteria for evaluating tax structures:
  - Equality
  - Convenience
  - Certainty
  - Economy

Criteria for Evaluating a Tax Structure (slide 2 of 2)

- In addition, the AICPA suggests that the tax system should be:
  - Simple
  - Neutral in terms of its effect on business
  - Clear and readily understandable
  - Structured to minimize noncompliance
  - Should not reduce economic growth and efficiency, and
  - Should enable the IRS to predict the amount and timing of revenue

Tax Structure (slide 1 of 2)

- Tax base: amount to which the tax rate is applied
- Tax rates: applied to the tax base to determine the tax liability
  - May be proportional, progressive, or regressive
- Incidence of tax: degree to which the total tax burden is shared by taxpayers

Tax Structure (slide 2 of 2)

- Examples:

Income	*$10*	*$20*	*$30*
Proportional Tax	$3 (.3)	$6 (.3)	$ 9 (.3)
Progressive Tax	$3 (.3)	$7 (.35)	$12 (.4)
Regressive Tax	$3 (.3)	$5 (.25)	$6 (.2)

Major Types of Taxes

- Property Taxes
- Transaction Taxes
- Death Taxes
- Gift Taxes
- Income Taxes
- Employment Taxes
- Other U.S. Taxes

Property (ad valorem) Taxes

- Based on the value of the asset
- Generally on realty or personalty
- Exclusive jurisdiction of states and their localities
- Deductible for Federal income tax purposes

Transaction Taxes

- Excise taxes
- General sales taxes
- Severance taxes

Excise Taxes

- Imposed at the Federal and state levels
- Restricted to specific items
  - Examples: gasoline, tobacco, liquor
- Declined in relative importance until recently

General Sales Taxes

- Currently jurisdiction of states and localities
- States that impose sales taxes also charge a use tax on items bought in other states but used in their jurisdiction
- States without sales or use taxes are Alaska, Delaware, Montana, New Hampshire, and Oregon

Severance Taxes

- Tax on the value of natural resources extracted
- Important revenue source for states rich in natural resources

Death Taxes (slide 1 of 2)

- Federal estate tax is on the right to pass property to heirs
  - Gross estate includes:
    - FMV of the property transferred at the date of death or,
    - If elected, the alternate valuation date (generally 6 months after date of death)
  - Certain deductions and credits allowed

Death Taxes (slide 2 of 2)

- State death taxes may be estate tax, inheritance tax, or both
  - Inheritance tax is on the right to receive property from a decedent
  - Tax is generally based on relationship of heir to decedent
    - The more closely related, the lower the tax

Unified Credit For Estate and Gift Taxes

- Unified credit reduces or eliminates the estate tax liability for modest estates
- Unified credit is $345,800 for 2003 which offsets tax on $1,000,000 of the tax base

Phaseout of Estate Tax

- The estate tax has been criticized for the hardship it imposes on small businesses and family farms
- Tax Relief Reconciliation Act of 2001 included the phase out of the estate tax
  - Unified transfer credit is scheduled to increase over a 10 year period
  - Due to be eliminated in 2010

Gift Tax (slide 1 of 3)

- Tax on the right to transfer assets during a person's lifetime
- Taxable gift = FMV of gift less annual exclusion less marital deduction (if applicable)
- Federal gift tax provides an annual exclusion of $11,000 per donee (adjusted for inflation)

Gift Tax (slide 2 of 3)

- Married persons can make a special election to split gifts
  - Allows 1/2 of a gift made by a donor-spouse to be treated as having been made by a nondonor-spouse
  - Effectively increases the number of annual exclusions available and allows the use of the nondonor-spouse’s unified transfer tax credit

Gift Tax (slide 3 of 3)

- The unified transfer tax credit is available for gifts (as well as the estate tax)
- Despite the eventual repeal of the estate tax, the gift tax has been retained with the unified transfer tax credit frozen at its current level ($345,800, covering $1,000,000 of taxable gifts)

Gift and Estate Unified Tax Schedule

- Gift and estate taxes are unified under a single tax rate schedule
  - Rates range from 18% to 50% on taxable transfers made during life and upon death
  - Since tax rates are progressive, prior years' transfers must be considered when calculating the current year's gift or estate tax

Income Taxes

- Imposed at the Federal, state, and local levels of government
- Base is taxable income (income less allowable exclusions and deductions)
- States not having a resident individual income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming

Formula for Federal Income Tax on Individuals Income (Slide 1 of 3)

Income (broadly conceived)	$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	$xx,xxx
Less: Certain deductions for AGI	(x,xxx)
Adjusted Gross Income	$xx,xxx

Formula for Federal Income Tax on Individuals Income (Slide 2 of 3)

Adjusted Gross Income	$xx,xxx
Less: The greater of:	
Itemized deductions, *or*	
The standard deduction	(x,xxx)
Less: Personal and	
dependency exemptions	(x,xxx)
Taxable income	$xx,xxx

Formula for Federal Income Tax on Individuals Income (Slide 3 of 3)

Tax on taxable income (see Tax Rate Schedules in Appendix A)	$ x,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	(xxx)
Tax due (or refund)	$ xxx

Corporate Income Tax

Corporate Taxable Income = Income - Deductions

- Does not require the computation of adjusted gross income
- Does not provide for the standard deduction or personal and dependency exemptions
  - All allowable deductions are business expenses

Employment Taxes (slide 1 of 2)

- FICA taxes
  - Paid by both an employee and employer
  - In 2003, Social Security rate is 6.2% on a maximum of $87,000 of wages, and Medicare rate is 1.45% on all wages
- Self-employment tax serves as FICA tax for self-employed taxpayers
  - Rate is 15.3%, base is net self-employment income, and deduction (FOR AGI) is allowed for 1/2 of self-employment tax

Employment Taxes (slide 2 of 2)

- FUTA (unemployment) taxes
  - Provides funds for state unemployment benefits for individuals that are laid-off or fired
  - In 2003, rate is 6.2% on first $7,000 of wages for each employee
  - Administered jointly by states and Federal government
  - Tax is paid by employer

Other Taxes

- Tariffs on imported goods
- Franchise taxes
- Occupational taxes

Proposed Taxes

- Flat tax
- Value added tax
- National sales tax

Tax Administration (slide 1 of 5)

- Internal Revenue Service (IRS)
  - Responsible for enforcing the Federal tax laws
  - Audits small percentage of returns filed using mathematical formulas and statistical sampling techniques for selection
    - Types of audits: correspondence, office, and field

Tax Administration (slide 2 of 5)

- Statute of limitations
  - Deficiency assessment by IRS
    - Generally 3 years from the later of the due date or the filing date of the return
    - For material (more than 25%) omissions of gross income, time period is 6 years
    - No statute if no return filed or fraudulent return filed

Tax Administration (slide 3 of 5)

- Statute of limitations
  - Refund claim by taxpayer
    - Generally 3 years from date return filed or 2 years from date tax paid, whichever is later

Tax Administration (slide 4 of 5)

- Interest and penalties
  - Interest accrues on the taxes due starting from the due date of the return and interest is paid on refunds if not received within 45 days of when the return was filed
  - Current rate is 5% (determined quarterly by the IRS)

Tax Administration (slide 5 of 5)

- Interest and penalties
  - Penalties apply for failure to file, failure to pay, underpayment of estimated taxes, negligence, etc.
  - Tax return preparer penalties also exist

Tax Practice (slide 1 of 4)

- Area of tax practice is largely unregulated
  - Members of professions must follow certain ethical standards (CPAs, Attorneys)
  - Various penalties may be imposed upon preparers of Federal tax returns who violate proscribed acts and procedures

Tax Practice (slide 2 of 4)

- Ethical guidelines issued by AICPA:
  - Do not take questionable position on client's tax return in hope of it not being audited
  - Client's estimates may be used if reasonable
  - Try to answer every question on the tax return (even if disadvantageous to client)
  - Upon discovery of an error in prior year tax return, advise client to correct

Tax Practice (slide 3 of 4)

- Statutory penalties may be levied on tax return preparers for:
  - Procedural Matters-Failure to:
    - Provide copy of return to taxpayer
    - Sign the return as preparer
    - Keep copies of returns
    - Maintain a client list

Tax Practice (slide 4 of 4)

- Statutory penalties may be levied on tax return preparers for:
  - Understatement of tax liability based on a position that lacks a realistic possibility of being sustained
  - Willful attempts to understate tax
  - Failure to exercise due diligence in determining eligibility for, or the amount of, the earned income tax credit

Understanding the Federal Tax Law (slide 1 of 3)

- The Federal tax law is the vehicle for accomplishing many objectives of the nation such as:
  - Raising revenue: the major objective of the tax system but not the sole objective
  - Economic: increasingly important objective is to regulate the economy and encourage certain behavior and businesses considered desirable

Understanding the Federal Tax Law (slide 2 of 3)

- Federal tax objectives
  - Social: encourage socially desirable behavior that provides benefits that government might otherwise provide
  - Equity: equity within the tax laws (e.g., wherewithal to pay concept) and not necessarily equity across taxpayers

Understanding the Federal Tax Law (slide 3 of 3)

- Federal tax objectives
  - Political: a large segment of the tax law is created through a political process; thus, compromises and special interest dealings occur
  - Ease of administration: many provisions are meant to aid the IRS in the collection of taxes
  - Courts: influence tax law and sometimes cause it to change

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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