Terminology Relevant to Taxation

- Income
  - Gross Income
  - Net Income
- Capital Gains
  - Basis
  - Adjusted Basis
  - Realized Gain or Loss
  - Recognition of Gain
- Deduction
  - Standard Deduction
  - Itemized Deductions
- Marriage Penalty

What is a “progressive” tax?

- A progressive tax is a tax whose rate increases as the entity’s taxable base increases. The U.S. income and estate taxes are examples of progressive taxes.

- The opposite is a “flat” tax, which stays the same, no matter the level of taxable assets. The sales tax is an example of a “flat” tax.

Who Pays Federal Income Tax?

- Individuals
- Trusts
  - The trust can pay the tax or,
  - The Trust can distribute the income to the beneficiaries who will pay their own income tax.
- Partnerships and LLCs
  - These are "pass through" entities and the owners pay as they would with ordinary income.
- Corporations
  - Subchapter S corporations are "pass through" entities.
  - Subchapter C corporations pay their own income tax.

The Advantage of Tax Deferral

- Tax Deferral allows one to earn the money now but pay tax on it later.
- This is useful because the taxpayer can earn income at compounded rates before the tax takes a “bite” out of the asset. It’s often best to “grow” assets first and reduce it by paying tax later.
- The taxpayer may also be in a lower tax bracket when it comes time to actually pay the tax!
- Present Value of an Asset = $\dfrac{\text{Future Value}}{(1+r)^n}$

r = interest rate earned n = number of years tax is deferred

Common Ways to Defer Taxes

- Traditional IRA
- SEP IRA
- 401(k) plan
- §1031 exchange (defers capital gains tax)

Income Tax Alternatives

- “Haig-Simons” income tax (similar to our system)
- Consumption Tax
  - Personal Consumption
  - Cash Flow Consumption
  - Yield Exemption Consumption
- Value Added Tax
- Straight Sales Tax

Sources of Tax Law

- The Internal Revenue Code (Title 26 of the USC)
- Case law in tax cases
  - Tax court decisions
  - Other federal court decisions
- Treasury Regulations promulgated by the Internal Revenue Service
- Revenue Rulings by the IRS
- Private Letter Rulings by the IRS
- Technical Advice Memoranda

Enforcement of Tax Law

- Internal Revenue Service (IRS) in charge of enforcement
- “Self-assessment” system
- 1-2% of returns are “audited” by the IRS.
- Possible results of an audit:
  - Revenue agent’s report, asserting a *deficiency*
  - IRS has an appeals office to hear deficiency appeals
  - Denied appeal will result in statutory notice of deficiency
  - After losing a service appeal, the taxpayer can:
    - Appeal in tax court; OR
    - Pay the deficiency and litigate in federal district court.
- In case of a deficiency, interest is always charged plus possible penalties for late filing or substantial inaccuracy.

Tax Law Research

- Primary (binding) Authority
  - Internal Revenue Code
  - Federal court decisions
  - Regulations
- Nonbinding authority
  - Tax court decisions
  - Revenue Rulings
  - Private letter rulings
- Other resources
  - Tax law treatises an practice guides
  - www.irs.gov
  - IRS hotline