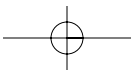
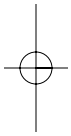
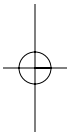
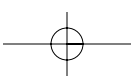
PART

one

Understanding Strategic Tax Planning: A Framework

CHAPTER 1

A Framework for Understanding Taxes

The claim that information would define the future reminded me of the famous party scene in the 1967 movie The Graduate. *A businessman buttonholes Benjamin, the college graduate played by Dustin Hoffman, and offers him a single word of unsolicited career advice: "plastics." I wondered whether, if the scene had been written a few decades later, the businessman's advice would have been: "One word, Benjamin: 'information.'"*

—Bill Gates, *The Road Ahead*

How much are people and organizations touched by taxes? Think about what people do every day. Buy a cup of coffee, and some sort of sales or value-adding tax is almost certainly included in the amount paid. Make a telephone call, and an excise tax is likely incurred. Earn income, and a significant portion of the compensation must usually be withheld for payroll taxes. Make money trading stocks over the Web, and a percentage of the profits will likely be dedicated to annual income taxes.

One conclusion that can be drawn from this thought experiment is that taxes seem to be everywhere, embedded in every transaction. This conclusion can be supported by the following set of simple experiments on the World Wide Web. First, get on a Web browser (e.g., Netscape or Explorer) and run an Internet search on the word "taxes." Consider the sheer number of hits generated by this simple task. Run the search again on the Web site of a national newspaper (such as *www.nytimes.com* or *www.economist.com*). How many articles discuss taxes? Finally, explore one of the gateway Web sites in taxation (e.g., *www.taxsites.com* or *www.taxworld.org*). As you may already know, a gateway is a Web site that consists primarily of links to other Web sites. Gateways are particularly handy for keeping track of the constant changes in Web addresses and for finding new sites. Be sure to look at the Web site for the U.S. Internal Revenue Service (IRS),

www.irs.gov, which was one of the first major sites for a governmental agency and is one of the most heavily used. Browse the various publications available there. How many are there? Other very interesting sites to explore are the U.S. Federal income tax calculator, *www.nettax.com,* and the free tax return preparation site, *www.hdvest.com*. It also may be worth your time and effort to view the history of taxation found at *www.uic.edu/depts/lib/collections/govdocs/tax/taxhistory.html,* and the "Hot Topics in Taxation" page of the University of Michigan's Office of Tax Policy Research at *http://209.69.116.53*.

One reason that taxes seem to be everywhere may be that they are a price paid for government. Not the total price: To some extent (and in many ways, both directly and indirectly), governments support themselves by charging users for specific services provided. For example, some local governments charge a monthly fee to owners of residences that are hooked up to municipal sewer systems. However, throughout the world governments are primarily financed through taxation. Taxes are charges not directly related to goods or services provided, which are imposed on people and organizations located within a government's legal reach. In many locations in the industrialized world, a multitude of governments and their subdivisions—ranging from cities to nations, school districts to metropolitan rapid transit districts—levy a myriad of taxes on a wide variety of activities, such as income taxes on business profits, property taxes on wealth, value-adding taxes on purchases, and payroll taxes on compensation.

Some taxes are periodic. For example, payroll taxes on employees are usually withheld from each paycheck, and income taxes are typically based on one year's earnings. Other taxes are generated if and only if certain transactions occur. For example, sales taxes are usually triggered by the retail sales of goods, and inheritance taxes may arise when title to property is passed to a person's heirs.

The primary purpose of most taxes is to raise revenue to finance governments. But because taxes impose costs on transactions, taxes affect people's behavior, and thus can (and are) used by governments to try to shape society. Indeed, the primary purpose of some taxes—such as excise taxes on the sale of machine guns, tobacco, and pollutants—is to further social engineering goals.

Taxes seem to be everywhere, and triggered by a bewildering array of activities, but how is strategic tax planning important to people who do not devote their lives to tax consulting?

HOW ARE TAXES IMPORTANT IN DECISION MAKING?

Sometimes taxation, and thus tax planning, is one of the most important factors in decision making. Consider the following scenario. Your best friend, who lives in New York City, e-mails you with the news that she has

just inherited a large amount of cash. She asks for your help in investing it in U.S. mutual funds, which primarily hold bonds. Look in a financial newspaper or Web site that shows the current earnings of various bond funds. Pick five at random, and calculate their average yield. Now do the same for five that have the words "tax exempt" or "municipal" in their names. (For the uninitiated, this means that these funds invest primarily in bonds issued by U.S. states and local government agencies. Interest paid on such securities is almost always exempt from U.S. federal income tax, and is often exempt from state income taxes as well.) What is the difference in the average yields of the first set of mutual funds and the tax-exempt set? Could a significant part of this difference be accounted for by tax effects?

Tax planning can affect decision making in even the most commonplace of settings. Consider the case of a typical U.S. homeowner whose annual property tax payment must be paid before January of the following year, and it is now December. Almost all people who pay U.S. federal income tax calculate the tax based on their net income—that is, their taxable revenues less their tax-deductible expenses—in each calendar year. Assume that the property tax is a deductible expense, and that the homeowner is in the 28% tax bracket. This means that every dollar of additional income results in $.28 in additional tax. Similarly, every dollar of tax-deductible expense saves $.28 in taxes. If homeowners pay the property tax in December, they will get a tax deduction on their tax returns for the current year. The tax benefit is delayed a year, however, if they wait until January to pay. That is, simply paying this deductible expense a few days earlier generates tax savings a year earlier. This simple bit of planning results in tax benefits through timing, an important component of strategic tax planning discussed in detail throughout this book.

Taxes can even affect the most nonfinancial of decisions. Consider the case of two people who want to get married. Should they be thinking about taxes? Suppose that each will earn about $30,000 of taxable income for the current year. If they stay single, each would owe a little over $5,100 of U.S. income tax for the year. Unmarried, about $10,200 of tax would be generated on their total income of $60,000. However, if they are married at the end of the year, their total tax bill would exceed $11,300. That is, the decision to get married would cost them over $1,000 in U.S. federal income taxes that year. (Note: federal tax liability can be quickly calculated in a variety of ways. One way is to use the tax tables provided by the IRS. These can be found on its Web site at *www.irs.gov* by clicking on "Forms and Publications," selecting "Forms and Instructions," and reviewing "Instructions 1040 [Tax Tables]. Another way is to purchase tax-preparation software or use Web-based programs such as those found at *www.hdvest.com* or *www.nettax.com*.)

Reducing marriage penalties like this has been a perennial target of tax legislation during the past few years. Under the Tax Relief Reconciliation

Act of 2001, for example, there are two changes in this area. First, on joint returns—that is, where married couples elect to file one tax return that combines their incomes—the standard deduction (discussed later in this chapter) is being changed. Currently, it is about 85% of that for two single filers. It is being increased to double that of single filers. This is being phased in over a four-year period starting in 2005 and ending in 2008. The current numbers are:

Standard Deduction

Filing Status	Married Filing Jointly	Single	Head of Household	Married Filing Separately
2001	$7,600	$4,550	$6,650	$3,800
2002	$7,850	$4,700	$6,900	$3,925

Two years are shown here so the gradual, across-the-board increases due to inflation indexing can be seen. *Indexing* applies to a variety of, but not all, fixed dollar amounts in U.S. tax law, such as the standard deduction, as well as that rate brackets.]

The second change is that the amount being taxed at the 15% rate for joint filers is being expanded. This is so that the upper limit of amount taxed at 15%—the so-called 15% bracket—will become twice that for single taxpayers, rather than the current 85%. The current rates are:

Tax Year 2002

Married Filing Jointly		Unmarried	
Taxable Income	**Rate**	**Taxable Income**	**Rate**
First $12,000	10%	Not over $6,000	10% of the taxable income
Over $12,000 but not over $46,700	$1,200 plus 15% of the excess over $12,000	Over $6,000 but not over $27,950	$600 plus 15% of the excess over $6,000
Over $46,700 but not over $112,850	$6,405 plus 27% of the excess over $46,700	Over $27,950 but not over $67,700	$3,892.50 plus 27% of the excess over $27,950
Over $112,850 but not over $171,950	$24,265.50 plus 30% of the excess over $112,850	Over $67,700 but not over $141,250	$14,625 plus 30% of the excess over $67,700
Over $171,950 but not over $307.050	$41,995.50 plus 35% of the excess over $171,950	Over $141,250 but not over $307,050	$36,690 plus 35% of the excess over $141,250
Over $307,050	$89,280.50 plus 38.6% of the excess over $307,050	Over $307,050	$94,720 plus 38.6% of the excess over $307,050

This change will be phased in from 2006 to 2008. Note that highlights of recent tax changes can be found at the various gateway tax sites already listed, as well as in IRS publications such as Publication 553.

Tax planning often represents a significant part of doing business. In some cases, taxes are one of the most important aspects in structuring a transaction. Consider Tax Management in Action 1.1.

This case study illustrates just how important taxes can be in a business transaction. DuPont was able to capture part of Seagram's tax savings by negotiating a lower price for the stock it bought back, and Seagram was able to transform what would have been a taxable transaction (had the DuPont stock been sold on the open market) into a largely tax-free transaction by using the tax law. Moreover, the transaction was motivated by both firms' strategic plans: Seagram, for example, wanted to acquire MCA for strategic business reasons. The decision to sell the stock was motivated by the strategic decision to purchase MCA; only the form—a stock redemption by Dupont of its own shares—was motivated by tax savings. This example shows how good tax planning can *add* significant value to a transaction. Although transactions typically do not have such dramatic tax

TAX MANAGEMENT IN ACTION 1.1

DuPont and Seagram

As part of its strategy on moving into the entertainment industry, Seagram's managment decided to purchase MCA from Matsushita. There were many ways to finance this acquisition. Seagram chose to do so primarily by selling 156 million of the 164 million shares it held in DuPont back to DuPont. One of the main reasons to do this was that, by having Dupont redeem the shares, the transaction could be treated for U.S. income tax purposes as a primarily tax-free dividend to Seagram rather than as a taxable sale. Being able to report the nearly $9 billion sale as a dividend saved Seagram at least $1.5 billion in taxes.

The tax savings helped finance Seagram's purchase of MCA, but Seagram was not the only winner. DuPont's reward for its role in the deal was the acquisition of a large block of its outstanding shares at a discount from market price of at least $740 million.

For more information, see Merle Erickson and Shiing-Wu Wang, "Exploiting and Sharing Tax Benefits: Evaluating Seagram's Financing/Tax Planning Decision in its Acquisition of MCA," *Journal of the American Taxation Association,* 21, No. 2 (Fall 1999): 35–54.

effects, the example illustrates how a transaction can have an important tax component.

Taxes are only one of the many factors that people and organizations consider when making decisions. In some cases, taxes are a dominant factor; in others, tax considerations play a minor part. Good decision makers generally seek to manage taxes on every transaction. One way to measure how well a firm is managing its taxes is to look at its effective income tax rate. A firm's effective tax rate is the sum of taxes paid by the firm, divided by its (before-tax) net income. Often, firms' effective tax rates exceed 40%. This is not surprising for multinational firms operating in the United States, because they usually are subject to 35% rate on U.S. income plus an assortment of international, state, and local taxes.

As shown in Tax Management in Action 1.2, even large firms can have widely varying effective tax rates. In the sample shown, however, all have rates well below 40%, which shows that these firms are managing their taxes.

These companies were able to reduce their tax burdens to rates below the benchmark 40% primarily by placing operations so that large proportions of taxable income were derived from locations with tax rates lower than the 35% rate typical for operations in the United States. To put some perspective on this, take a closer look at Johnson & Johnson. By bringing its effective tax rate down to 23%, it saved $270 million in taxes. These tax savings were due to a large proportion of its taxable income being derived from Puerto Rico, which allowed the company to enjoy the U.S. possessions' tax credit. Locating operations in low-tax locations uses the strategic

TAX MANAGEMENT IN ACTION 1.2

Effective Tax Rates

Firm	World-Wide Effective Tax Rate
General Motors	36%
Microsoft	33%
Johnson & Johnson	23%
McDonnell-Douglas	35%
Disney	35%
IBM	38%
General Electric	24%
Citicorp	26%

Source: Financial Statements in Individual Firms' Form 10K Reports (1993–1995)

tax planning mechanism of *transforming,* which is discussed throughout this book (and in detail in Chapters 7 and 8).

TYPES OF TAXES

As already suggested, government regulation can be an important factor in economic decision making. This book is intended to help people learn how to better factor the impact of regulation into decision making by studying the effect of one prominent kind of regulation: taxation. Throughout the world, various levels of government impose an array of taxes in order to raise revenue or shape the behavior of people and organizations. This is illustrated by the following overview of taxes in one of the world's most important economies, the United States. The United States was also chosen because although it has one of the most complex systems of taxation, it also has one of the most explicit and documented tax systems in the world. For these reasons, most of the examples in this book are drawn from the United States, and its most important tax, the national income tax.

U.S. Federal Taxes

The U.S. government raises the vast majority of its revenues through taxes. (Statistics showing amounts and trends by type of tax can be found on the Web at sites like *www.taxworld.org, www.taxsites.com,* and the IRS site, *www.irs.gov.*) The major types are corporate and personal income taxes, payroll taxes, estate and gift taxes, excise taxes (e.g., on tobacco, alcohol, and air travel), and import duties. Because collections of excise taxes and duties are fairly small and straightforward, they are not elaborated upon further in this book. (For a discussion of the relative importance of different types of taxes—both in the United States and the rest of the world—explore the Web sites reached by clicking on "policy-reform" in sites like *www.taxsites.com* and the University of Michigan's Office of Tax Policy Research at *http://209.69.116.53.*) For similar reasons, the discussion on U.S. taxes will begin with estate and gift taxes.

Estate and Gift Taxes

Gift taxes are imposed when one person gives property to another with non-business motives like affection and appreciation. Estate taxes are imposed on a person's last gift: the transfer of property to heirs at one's death. In this sense, these two complementary taxes are really one unified tax on gifts people give either while they are alive or when they die. (There is another related tax, too: the generation skipping transfer tax. Because it is

extraordinarily complex and rarely triggered, it is not discussed further in this book.) Both of these taxes are imposed on the transferor of property, not on the recipients, and are based on the fair market value of the property transferred. In addition, both use the same tax rates. (For more information on this and other topics, check Web sites mentioned previously, like *www.taxsites.com,* or go to the IRS Web site and see IRS Publication 950, *Introduction to Estate and Gift Taxes*. For example, see what you get when you go to the IRS Web site, click on "Forms and Publications," click on "Search for a Form or Publications," and input the term "gift tax" into the search engine.)

The intent of these taxes on gratuitous transfers of property is not so much to raise revenue as to try to prevent excessive concentrations of hereditary wealth. In doing so, these taxes help provide additional vertical equity in the tax system beyond that provided by the income tax. That is, estate and gift taxes attempt to impose additional taxes on wealthier individuals. Both taxes are steeply progressive, which means that tax rates increase as the tax amount increases. The top rate is 55%. Note that there are no U.S. taxes on the recipients of bona fide gifts or inheritances (although some states in the United States impose such taxes). In addition, recipients do not pay income taxes on gifts or inheritances, nor are income taxes imposed on givers when appreciated property is transferred.

The gift tax is imposed on individuals who transfer property in a bona fide gift. A *bona fide gift* has a donative intent, with no strings attached to the recipient. That is, it is not a disguised sale or form of compensation. There are numerous exceptions to the tax, making its payment fairly rare. The most important exemptions are for transfers of property between spouses (both during marriage and upon divorce) and most donations to public institutions such as charities, universities, and churches (which also are exempt from income tax). In addition, small gifts are not taxed. For example, there is an annual exclusion amount of $10,000 per year per donor per donee. If the donor is married, the gift can be treated as if it came from both spouses, in which case the annual exclusion doubles to $20,000. The annual exclusion is a simple tax-planning method that can be used to avoid taxes when large gifts are given in installments. (See Example 1.1.)

EXAMPLE 1.1

Mr. and Mrs. Smith wish to give their son $100,000. They also want to give $30,000 to their church and $500 to their neighbor's son. However, they would like the neighbor's son to periodically mow their lawn, in return for the $500. What are the gift tax consequences? The donation to the church is not subject to tax. Neither is the $500 to the neighbor's son, because it is not a bona fide gift but taxable compensation to him. The use of the annual

exclusion reduces to $80,000 the amount subject to tax on the gift to the son. Note that if the Smiths instead give their son $20,000 per year for five years, gift taxes are avoided altogether.

Like the income tax, gift taxes are calculated and paid annually. Unlike the income tax, the gift tax is a lifetime tax, which is figured by including in the amount subject to gift tax for a year—the gift tax *base*—both the taxable gifts made during the year and all taxable gifts made in prior years (but only those since 1976, when the current unified system was enacted). However, prior gifts are not double-taxed. This is because a credit for the tax on prior gifts is allowed against the current year's tax. That is, every dollar of taxes on gifts made in prior years offsets a dollar of taxes calculated for the current year. Because of the progressive rate structure, which results in increasingly higher rates in each successive year until the top bracket is reached.

Another credit—the unified credit—assures that most people never actually have to pay gift taxes. This credit effectively exempts the first $1 million worth of property (over and above the annual exclusion) given away by any one taxpayer. Under the Tax Relief Reconciliation Act of 2001, U.S. estate and gift taxes are being phased out over a 10-year period. This is being done partly by reducing tax rates and partly by raising the unified credit. The timetable is:

Year	Maximum Tax Rate	Unified Credit
2002	50%	$1,000,000
2003	49%	$1,000,000
2004	48%	$1,500,000
2005	47%	$1,500,000
2006	46%	$2,000,000
2007	45%	$2,000,000
2008	45%	$2,000,000
2009	45%	$3,500,000
2010	0	0
2011	55%	$1,000,000

Due to the vagaries of the U.S. legislative process, these changes could not be extended beyond 2010. Thus, although the taxes disappear in 2010, they will reappear in 2011 unless the changes are extended sometime before then. The changes were enacted in an atmosphere of large budget surpluses projected over many years. Budget deficits are now projected, suggesting that federal taxes may be raised, directly or indirectly, in the near future.

Because of the unified credit, the Smiths of Example 1-1 would not actually have to pay any gift taxes on the $80,000 amount, unless they had

made over $1,920,000 ($1,000,000 for Mr. Smith plus $1,000,000 for Mrs. Smith, less the $80,000 taxable gift) of prior taxable gifts. (Such gifts would be included in the Smiths' gift tax base.) Unlike the $10,000 exclusion, which is renewed every year, the unified credit is a lifetime amount. Although the credit can be used in pieces over a period of years, the total credit is not renewed every year. In other words, the Smiths would not avoid gift taxes if they gave away $2 million every year.

The estate tax is imposed on the net taxable estate of someone who dies. This is the fair market value of the decedent's assets at the time of death, plus the sum of prior taxable gifts, reduced by the decedent's liabilities and by certain deductions. The most important deduction is for property left to a surviving spouse. Because of this, the estate tax is effectively a tax on the joint life of a married couple. Deductions also are allowed for contributions to be made out of the estate to qualified public institutions (i.e., the tax-exempt organizations already mentioned), and certain funeral, administrative, and miscellaneous expenses. The combined estate and gift tax is a lifetime tax. Although prior taxable gifts are included in the amount subject to the estate tax (i.e., the estate tax base), gift taxes previously paid are creditable. That is, every dollar of prior gift tax offsets a dollar of estate tax. Because of the progressive estate tax structure, the effect is to tax property passed at death—effectively the last gift people can make—at the highest possible estate tax bracket.

To reduce double taxation—once by the Federal government, and a second time by state governments—there is a credit for state estate or inheritance taxes paid. More important, the unified credit assures that most people never pay an estate or gift tax. As noted, this credit currently exempts the first $1 million given away over and above the $10,000 per year annual gift tax exclusion throughout one's life. The balance of the unified credit not used up during one's lifetime can be used to offset estate taxes. Thus, because most people in the United States have net estates of less than $1 million, few people are concerned about the tax. In addition, as with the gift tax, one of the easiest ways to avoid the tax is by giving one's estate to a tax-deductible beneficiary, such as a charity or a surviving spouse. (See Example 1.2.)

EXAMPLE 1.2

Mr. Jones dies in 2002, leaving behind a wife and a son. The total fair market value of assets in his estate is $10 million, and there are $2 million in liabilities. He has made no prior taxable gifts. According to Jones' will, $5 million will go to his wife, with the remainder going to his son. His taxable estate is $10 million – $2 million – $5 million – $1 million = $2 million.

Income Taxes on Individuals

In the United States, individuals pay a national personal income tax on taxable income received during the year. (More details are available on the Web, e.g., IRS Publication 17, *Your Federal Income Tax,* available at *www.irs.gov*.) As discussed later, most states and some cities also impose a personal income tax modeled after the national system (albeit at lower tax rates). Taxable income is computed as

Gross Income – Deductions for Adjusted Gross Income (AGI) =
AGI – Deductions from AGI = Taxable Income

Gross income includes any realized income that is not subject to an exclusion. For individuals, this typically includes salaries and wages (including year-end bonuses), dividends, interest, rents, royalties, distributions from retirement accounts, and gains (net of losses) on the sales of assets. Adjusted gross income (AGI) is calculated by subtracting the "above the line" deductions (because they are reported on the front of the tax return form). "For" AGI deductions generally are limited to those relating to sole proprietorships, rent and royalty income, and losses on sales of property.

There are two classes of deductions "from" AGI. Both of these are subject to a phase-out for higher income taxpayers, the details of which are not important here but can be found at sites like *www.taxsites.com*. The first class comprises personal and dependency exemptions. The taxpayer receives a tax deduction for self, spouse (if married), and for each dependent. For the year 2002, the amount of the exemption is $3,000 per person. Basically, a dependent is a low-income person being supported by the taxpayer. Whether someone qualifies depends on a five-pronged test, which is surprisingly complex. (As already suggested, those interested in learning more can find a wealth of detail on the Web, such as IRS Publication 501, *Exemptions, Standard Deductions, and Filing Information.*) For a typical taxpayer, the taxpayer's minor children are the dependents. Thus, a married couple with two dependent children would have a $12,000 exemption for the year 2002.

The second category of deductions from AGI is the greater of the standard deduction, or the sum of the taxpayer's itemized deductions. Itemized deductions fall into six classes:

1. Medical and dental
2. Home mortgage interest
3. Charitable contributions
4. Casualty and theft losses
5. State/local/foreign income, and property taxes
6. Miscellaneous

The last category includes items like union dues and employee business expenses, but only if, in total, they exceed 2% of AGI.

The standard deduction is a set amount that varies by the taxpayer's filing status. The numbers for 2001 and 2002 are listed in the first section of this chapter, "How Are Taxes Important in Decision Making?" Filing status, which is limited by a host of detailed rules, comprises the categories single person, married filing jointly, married filing separately, or head of household (typically, a single parent). Filing status is important because it also determines the level of tax rates. Married filing jointly has the lowest, followed by head of household and single.

Tax rates on individuals currently range from 10% to 39%. As previously noted, the United State's income tax is progressive, with higher levels of taxable income being taxed at higher rates. An exception is for net long-term capital gains, which is one of the most complex areas of U.S. taxation. Indeed, one of the longest sentences in the U.S. tax statutes deals with a certain definition relating to long-term capital gains. Consisting of over 500 words, it is 26 United States Code (U.S.C.) Section 341(e)(1). It, along with all of the other U.S. tax statutes (which are typically referred to as the Internal Revenue Code) can be found through various Web sites, including *http://uscode.house.gov/usc.htm*.

Under the Tax Relief Reconciliation Act of 2001, United States income tax rates are scheduled to be reduced in phases over the period 2002–06. The timetable is:

Calendar Year	15% rate	27% rate	30% rate	35% rate	38.6% rate
2002–2003	Partial 10%	27%	30%	35%	38.6%
2004–2005	No change	26%	29%	34%	37.6%
2006 and later	No change	25%	28%	33%	35%

The dramatically unexpected switch from projected U.S. budget surpluses to deficits suggest that phased income tax reductions may be a target for budget-balancing legislation in the near future.

Profits from sales of property other than inventory are generally classified as capital gains. Gains are considered long term if the asset sold has been held for at least 12 months. Capital gains and losses are netted every year, and the maximum tax rate on most kinds of net long-term capital gains is 20%. An exception to this exception is that if the taxpayer's normal tax rate is at the lowest tax bracket, 15%, the maximum rate on that taxpayer's net long-term capital gains is 10%. Certain longer-term gains can be taxed at a maximum of 18% (8% for taxpayers in the lowest tax bracket.) Another exception is for unrecaptured Section 1250 gain, which

is generated when certain real estate that has been depreciated is sold at a profit. This gain is subject to a maximum rate of 25%. A final exception is for gains on collectables—such as art, stamps, and coins—which are taxed at a maximum 28% rate. The treatment of capital gains is discussed further throughout this book, in particular, Chapter 10 and the "Transforming" sections of Chapters 2, 3, and 4, which deal with issues such as the choice of the optimal legal form for operating business, executive compensation, and shutting down a business operation. (See Examples 1.3 through 1.6.)

EXAMPLE 1.3

A taxpayer has the following transactions for the year: long-term capital gain of $1,000, long-term capital loss of $200, short-term capital loss of $300, and short-term capital gain of $400. Assume the long-term gains have been held more than 12 months and that the taxpayer's ordinary income tax rate is 36%.

The netting process yields:

	Short Term	Long Term
	<$300>	$1,000
	400	<200>
NET	$100	$ 800

The $100 short-term gain is taxed at 36%; the net long-term gain of $800 is taxed at 20%.

EXAMPLE 1.4

Assume the same facts as Example 1.3, except that the taxpayer's ordinary income tax rate is 15%. Then, the $800 net gain is taxed at 10%.

EXAMPLE 1.5

Assume the same facts as in Example 1.4, except that the net short-term amount is a loss of $100. In this case, the long-term and short-term amounts are also netted, resulting in net long-term gain of $700, which is taxed at 20%.

EXAMPLE 1.6

Assume the same facts as Example 1.5, except that there is a net long-term loss of $800. Here, the long- and short-term amounts are netted together,

resulting in a net long-term loss of $ 700, which is fully deductible (because it does not exceed $3,000).

Capital losses are not tax favored. Individuals can only deduct $3,000 per year of net capital losses; any excess is carried forward to be used in future years either to offset capital gains or for a deduction of $3,000 per year. Interestingly, although business fixed assets held more than a year generate long-term capital gain, net losses are ordinary, not capital, and thus do not run afoul of the $3,000 limitation.

Income Taxes on Business Entities

There are a variety of legal forms through which businesses can operate in the United States. As discussed in greater detail in Chapter 3, these include sole proprietorships, partnerships, corporations, and limited liability companies (LLCs). There are tax and nontax benefits and disadvantages to each one of these entities. For income tax purposes, however, business entities in the United States fall into two general classes: regular corporations and flow-through entities. Regular corporations are called C corporations because the basic tax rules governing them are found in subchapter C, Chapter 1, subtitle A of the Internal Revenue Code. This contrasts with corporations that qualify for and maintain a special tax election under Subchapter S, to be taxed as a flow-through entity. These are called S corporations.)

C corporations are taxed on their income, and their shareholders are taxed again when income is distributed to them. Flow-through entities generally are not taxed at the entity level. Instead, the income of a flow-through entity is taxed directly to its owners. This is the case for both income distributed to owners and that which is not. However, when such previously taxed undistributed income is passed out to owners, there is not a second tax. Flow-through entities include partnerships, limited liability companies, and S corporations, and are discussed in more detail in Chapter 3.

The most important general tax rules that apply across business entities are the following:

- ***Methods of accounting.*** Entities must choose an accounting method that clearly reflects income. The generally acceptable methods are cash, accrual, and hybrid (cash for some items, accruals for others). The cash method has the advantage of giving more control to the taxpayer over the timing of income and deductions. The cash method can be used by noncorporate entities (except for those that maintain inventories) and

corporations that have gross receipts of $5 million or less or that perform personal services as their primary source of income. In other cases, the accrual method must be used. Even if not required, the accrual method can be elected, although quite often it is not advantageous to do so.

- ***Year-ends.*** Flow-through entities (partnerships, LLCs, and S Corporations) usually must choose the same year-end as the majority of the entity's owners. In most cases this implies a calendar year, because almost all individuals elect to be calendar-year, cash-basis taxpayers. Corporations can choose either a calendar or a fiscal year-end. Year-ends (and accounting methods) are elected when taxpayers file their first tax returns; changes normally require the permission of tax authorities, such as the IRS.
- ***Depreciation.*** For financial accounting purposes, the costs of acquiring plant, property, and equipment are typically written off over the property's estimated useful life using straight-line depreciation. Because managers usually want to report the highest income they can, if they can elect to delay accruals, for example, by using straight-line instead of accelerated depreciation, they will do so. For tax purposes, *personalty* must be depreciated using fixed useful lives based on asset classes. (Personalty are assets that are not realty; *realty* consists of real estate and assets permanently affixed to real estate.) Although the straight-line method can be used, managers typically elect to use accelerated methods. The accelerated methods fall under the modified accelerated cost recovery system (MACRS). Most personalty fits into the 3-, 5-, 7-, or 10-year useful life category. Cars, trucks, and some equipment are depreciated over five years, and most equipment over seven years. The MACRS tables for these four asset categories are shown in Exhibit 1.1.

  Note that a half year's depreciation is allowed in both the first and the last year of the asset's life. Special rules apply in certain circumstances, such as where the majority of a firm's assets for a year are acquired in its last half (or quarter) of the year, or where assets are sold before the end of their full recovery period. (See Example 1.7.)

EXAMPLE 1.7

Assume a business acquires and places into service a light-duty truck in January for $20,000. Because it is a five-year asset, the depreciation for the year is $20,000(.20) = $4000. Depreciation for the next year would be $20,000(.32) = $6,400.

EXHIBIT 1.1 Percent Depreciation, by Year, for Personalty

Recovery Year is:	Recovery Period is:			
	3-Year	5-Year	7-Year	10-Year
1	33.33	20.00	14.29	10.00
2	44.45	32.00	24.49	18.00
3	14.81	19.20	17.49	14.40
4	7.41	11.52	12.49	11.52
5		11.52	8.93	9.22
6		5.76	8.92	7.37
7			8.93	6.55
8			4.46	6.55
9				6.56
10				3.28

Like many countries, the United States allows very rapid depreciation in certain circumstances. For example, profitable small businesses can elect to expense up to $24,000 ($25,000 after 2002) per year of most capital expenditures for personalty. Another example is the 30% additional first year bonus depreciation, which applies to most new personalty and qualified leasehold improvements, that was added by the Job Creation and Worker Assistance Act of 2002.

Realty (other than land) is depreciated straight-line. (Amounts can be found in IRS tables.) A 27.5-year period is used for residential rental realty, and 39 years is used for other realty, unless the firm elects to use the longer lives under the alternative depreciation system (ADS). (Thus, annual depreciation can often be calculated simply by dividing a building's cost by either 27.5 or 39.) For the year of acquisition, and the year of disposition, only part of a year's depreciation is allowed. This amount is based on the number of months of the year the asset is held, with a half-month's depreciation being allowed for the first and last month held. (See Example 1.8.)

EXAMPLE 1.8

Assume a business acquires a warehouse in January for $1 million. Depreciation for that year would be $1,000,000/39 = $25,641. This would also be the depreciation in all subsequent years until the year of disposition.

Income Taxation of Corporations

Although the majority by number of businesses operating in the United States are sole proprietorships, the majority of value-adding businesses are C corporations. (Throughout this book, the term *corporation* will refer to C corporations, unless indicated otherwise.) This is primarily because publicly traded companies cannot elect "S" status. There are two main advantages to operating in the corporate form. First, the owners (shareholders) can lose their investment in case of bankruptcy or lawsuit. (An exception is officers and directors, who may have some personal liability for their own actions.) Second, large amounts of capital can be raised through the capital markets (e.g., public offerings of a corporation's own common stock). The major tax impact of choosing the corporate form is that a C corporation's net income is subject to corporate income tax and, in addition, a second tax on distributions to shareholders, resulting in a double tax.

Note that this double tax occurs only when a corporation has taxable income and pays a dividend to a taxable shareholder. No double tax arises for corporations that show no profits (like many family-owned firms) or pay no dividends (like many growth stocks such as Microsoft). Nor is there a double tax when dividends of profitable corporations are paid to tax-exempt shareholders, such as qualified pension plans, mutual funds, and charities.

Corporations pay an annual tax on their taxable income, which consists of taxable revenues less deductible expenses. The tax rates in Exhibit 1.2 apply.

These U.S. corporate income tax rates are from Internal Revenue Code Section 11, which, along with the rest of the code, can be found through a variety of Web sites, (e.g., *www.taxsites.com*). The rates are progressive. For example, a corporation with $200,000 of taxable income would pay tax of

EXHIBIT 1.2 U.S. Income Tax Rates for Regular Corporations

Over	But not over	Tax is	Of the amount over
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	0

(15% × $50,000) + (25% × $25,000) + (34% × $25,000) + (100,000 × 39%) = $61,250. Once a corporation has taxable income beyond $325,000, all of its income is effectively taxed at a flat 34% rate. For taxable incomes beyond $18,333,333, the tax rate is a flat 35% on all taxable income.

Taxable income is income from the firm's financial statements, with some adjustments. These are discussed in detail in Chapter 12, but the major adjustments are for subsidiaries operating outside the United States, net operating losses (NOLs), dividend income, and depreciation on machinery and equipment.

The following rules are most commonly applicable to corporations. The tax rules are compared to the typical financial accounting treatment.

- ***International Operations.*** Under financial accounting, net income from international operations is typically included in the firm's consolidated income statement. For tax purposes, the tax treatment is identical for noncorporate overseas operations. That is, such overseas income is included in the consolidated firm's taxable income. However, if such income is generated by an affiliated overseas corporation, the income is not taxed until it is repatriated, typically as a dividend or a royalty. (See Examples 1.9 and 1.10.)

EXAMPLE 1.9

A major corporation has an unincorporated branch located in London. For the last year, the London branch had $1 million in net income. It sent $400,000 of cash back to its U.S. parent during that year. The U.S. parent will pay U.S. taxes on $1 million.

EXAMPLE 1.10

Assume the same facts as in Example 1.9, except that the London business is a corporation. Here, there is U.S. tax only on the $400,000 dividend. The remaining $600,000 of profits will not be taxed until the money is repatriated.

- ***Net Operating Losses.*** For financial-reporting purposes, net losses cannot be carried forward (or backward) from prior (or future) years. However, for tax purposes, such losses are allowed as a deduction to reduce the current year's taxable income. NOLs generated can be carried back five years and forward 20 years. There are special rules that apply to consolidated entities, as discussed in Chapter 14. (See Examples 1.11 and 1.12.)

EXAMPLE 1.11

A corporation has a net loss of $1 million during 2002. Its taxable income for 1997 and 1998 were $100,000 and $2 million, respectively. The firm paid $20,000 in taxes in 1997, and was in the 35% bracket in 1998. First, it carries back $100,000 of the NOL to 1997, and receives a refund of the $20,000 taxes paid. Next, it carries back $800,000 to 1998, and receives a refund of (.35)($800,000) = $280,000 of the 1998 taxes paid.

EXAMPLE 1.12

Assume the same facts as in Example 1.11, except that in 1998 the firm had taxable income of $500,000. Here, the firm gets a $20,000 tax refund from 1997. But the refund related to the 1998 taxes is limited to (.35)($500,000) = $175,000. The remaining $400,000 of the NOL will be carried forward to 1999.

- ***Contributions to Charitable Organizations.*** For financial-reporting purposes, contributions given to charitable organizations are an expense. The same is true for tax purposes, except that the total expense deducted in any one year cannot exceed 10% of taxable income (before the dividends received, NOL, and charitable contributions deductions). Contributions in excess of the limit are carried forward five years. Additional limits apply to contributions made to organizations other than qualifying public organizations (e.g., most recognizable charities, universities, and churches). (See Example 1.13.)

EXAMPLE 1.13

A corporation has the following operations for the year:

Sales revenue	$ 5,000,000
Cost of goods sold	<4,500,000>
Gross profit	500,000
Charitable contributions	<100,000>
Other operating expenses	<300,000>
Net income	100,000

Assuming all the items of income and expense shown are the same for financial and tax purposes, the limit for charitable contributions is (10%)($500,000 – $300,000) = $20,000. Therefore, taxable income is:

$500,000 – $300,000 – $20,000 = $180,000. The excess $80,000 of charitable contributions is carried forward to the succeeding five years.

- ***Capital Losses.*** For financial purposes, losses on sales of assets are expensed as they are incurred. For tax purposes, losses on sales or other dispositions of capital assets can be deducted only to the extent of current year capital gains. If losses exceed gains, the excess losses are carried back three years, and forward five years. (See Example 1.14.)

EXAMPLE 1.14

A corporation has two capital transactions for the year: a capital gain of $1 million and a capital loss of $1.5 million. The two are netted together, to give a net capital loss of $500,000. The loss must be carried back three years, and if still unused, forward five years.

- ***Goodwill.*** For financial reporting in most countries, acquired goodwill is not amortized. In the United States, it is tested annually to see if a portion must be expensed to reflect any impairment in its value. For U.S. tax purposes, goodwill is amortized straight-line over 15 years. (See Example 1.15.)

EXAMPLE 1.15

A corporation buys another corporation for $50 million, when the fair market value of the acquired corporation's assets is $45 million. The excess $5 million is considered goodwill. Each year, $5 million/15 = $333,333 amortization expense is deducted on the acquiring firm's tax return.

- ***Warranty and Bad Debts Expense.*** For financial purposes, both are accrued using estimation methods derived from experience. For tax purposes, warranties (bad debts) can be deducted only as they actually come due (go bad). (See Example 1.16.)

EXAMPLE 1.16

A corporation makes $10 million in credit sales during the year. Based on historical experience, 10% of the receivables will never be collected. During the year, customers actually default on $300,000 of receivables. Even though the bad debt expense for financial accounting purposes is $1 million, the deduction for bad debts is only $300,000 for tax purposes.

- ***Officers' Life Insurance.*** Premiums paid by the corporation on a life insurance policy, of which the firm is the beneficiary, are expensed for financial-reporting purposes. They are not deductible for tax purposes. Interest on any money borrowed to buy the insurance is not deductible for tax purposes, but it is an expense for financial accounting.
- ***Inventories.*** For financial-accounting purposes, firms can use a number of inventory-accounting methods. These include the FIFO (first in, first out method), several LIFO (last in, first out) methods, specific identification, and weighted average. Similarly, for tax purposes firms can use any method that clearly reflects income. One restriction is that if the firm elects LIFO for financial-reporting purposes, it must do so for tax purposes as well. For this reason, managers typically use the same method for both books and taxes.
- ***Dividend Income.*** For financial-reporting purposes, intercompany dividends are eliminated from net income in consolidated financial statements. Under U.S. generally accepted accounting principles (GAAP), the financial results of subsidiaries are combined with that of their parent into one consolidated statement. However, to avoid duplication, all intercompany transactions—like sales or dividends—are subtracted out (eliminated.) This is done for all subsidiaries of which the parent corporation owns at least 50%.

  For tax purposes, dividends are also eliminated if they are from a subsidiary included in a parent corporation's consolidated tax return. (To be included, the subsidiary must be domestic and at least 80% owned by the parent.) Otherwise, the method used to avoid double taxation is the dividends-received deduction. The deduction applies only to dividends paid out of a corporation from its U.S. source income. If the recipient corporation owns between 20 and 80% of the payor, the deduction is 80% of dividends. If less than 20% is owned, the deduction is 70%. Thus, for the latter two ownership percentages there will be a book-tax difference. (See Examples 1.17 and 1.18.)

EXAMPLE 1.17

A corporation has the following from operations during the year:

Sales revenue	$10,000,000
Cost of goods sold	<8,000,000>
Gross profit	2,000,000
Dividend income	1,000,000
Operating expenses	<1,000,000>
Net income	$ 2,000,000

If the dividends are from companies of which the firm owns only a small percentage, then the dividends-received deduction is (70%) ($1,000,000) = $700,000. Thus, taxable income is $2,000,000 – $700,000 = $1,300,000.

EXAMPLE 1.18

Assume the same facts as in Example 1.17, except that the dividends are from a subsidiary that is 100% owned by the parent. Taxable income thus is $2 million – $1 million = $1 million.

There are a number of other special tax rules that cause such book-tax differences. They will be discussed later in this book, particularly in Chapter 12.

Other Country Taxes

Most jurisdictions apply whatever taxes they impose on all transactions taking place in their territory. Thus, for example, the United States taxes foreigners on income from sources located within the United States (such as rents from U.S. real estate) and from businesses operating in (i.e., effectively connected with) the United States. Similarly, U.S. citizens or residents may be taxed by other countries on income from sources within those countries. International tax issues are discussed throughout this book, particularly in Chapter 8.

Gateway Web sites, such as *www.taxsites.com* and *www.taxworld.org*, provide excellent pathways to authoritative information on taxes worldwide. Some of the more user-friendly sites that can be found this way are those of the Big Four international professional advising (accounting) firms listed in Tax Management in Action 2.2. For example, current news on value-adding taxes throughout the world is streamed on PricewaterhouseCoopers' Global VAT OnLine Web page at *http://www.globalvatonline.pwcglobal.com/*

Similar to the United States, the taxes of most jurisdictions fall into three categories: transactions taxes, wealth taxes, and income taxes. The two most prevalent transaction taxes worldwide are value-adding taxes (VATs) and import duties. Import (and sometimes export) duties are taxes that are imposed on the flow of goods across most international borders. Notable exceptions are flows among members of free trade zones, such as the United States, Canada, and Mexico (NAFTA) and the European Union. Value-adding taxes exist in only a few countries outside the European Union (e.g., Canada's Goods and Services Tax) and not in the United States. Countries that do impose a VAT tend to be larger, wealthier, and more industrialized than those that do not.

VAT is imposed on buyers at each stage of a product's value-adding chain, based on the value-adding at that point. For example, suppose a

country has a 10% VAT. If a manufacturer sells its product for $100 to a retailer, and the cost to manufacture it is $80, the VAT is 10% of ($100 – 80) = $2. The manufacturer collects the $2 from the retailer and remits it to the government. If the retailer adds $1 of packaging costs and resells it to a consumer for $110, the consumer pays the retailer a VAT of 10% of ($110 – 100 – 1) = $1(rounded), which the retailer remits to the government. Note that some purchases (such as medicine or a new home) may be exempt from the tax, and some sales (such as those to other countries) are zero rated. This means that the seller enjoys a tax credit for the VAT it paid when acquiring the materials for the goods and services it exports, providing companies in some countries a large incentive to export.

Wealth taxes are imposed by most jurisdictions, typically in the form of property taxes. They are primarily levied on real estate and are usually based on the property's market value. Income taxes are usually the most significant foreign taxes paid by U.S. companies. These taxes are usually levied on in-country income only, with definitions of taxable incomes varying widely. Tax rates vary widely as well. Independent of taxable income definitions and tax rates, tax treaties between a number of countries and the United States reduce the real tax burden to a much lower rate. Additionally, to make sure that both the United States and the foreign country do not tax the same income, the United States allows a U.S. company to reduce its taxes by its foreign income taxes paid. Chapter 8 contains a more detailed discussion of taxation throughout the world, and the features of U.S. tax law that mitigate the specter of multiple taxation of income generated by cross-border activities.

State and Local Taxes

A survey by PricewaterhouseCoopers LLP found that corporate tax managers spent 44% of their time on state and local taxes. State and local taxes also fall into the categories of transaction, wealth, and income taxes. Sales and use taxes are paid by retail consumers of goods. They are remitted to businesses, which in turn remit these transaction taxes to local governments. The primary wealth tax is a property tax, assessed to owners of both realty and personalty. Forty-four of the states impose a corporate income tax. To partly alleviate double taxation, state corporate income taxes are deducted (expensed) on the federal corporate return (i.e., they reduce the U.S. tax bill). State and local taxes are discussed in more detail in Chapter 7.

BASIC PRINCIPLES OF TAXATION

People making decisions face a bewildering array of taxes, imposed by a variety of governments, that can have significant impacts on the results of decisions made. Complicating the process is the uncertain nature of tax

rules. Unlike the laws of nature, tax rules are social constructs resulting from political processes. They often result from the complex interaction of a host of official and unofficial actions taken (or not taken) by different governmental representatives at different times. U.S. Federal income tax, for example, is governed by hundreds of pages of the Internal Revenue Code, annual changes to which are explained in thousands of pages of congressional committee reports. These, in turn, are interpreted in tens of thousands of pages of IRS regulations, rulings, and publications, not to mention judicial opinions. These opinions summarize the thought processes of judges deciding cases that arise from controversies between taxpayers and the IRS that have not been resolved through administrative appeals within the IRS but instead are litigated in various U.S. courts.

It is fair to say that no one knows all of the tax rules that apply to many decisions. Nor will one person know all of the tax rules that may affect the result of many decisions, because results can take place in the future, and tax rules can change. However, like many fields of intellectual endeavor, more important than an encyclopedic knowledge of all of the rules is having a critical mass of knowledge that allows decision makers to ask the right questions. (The focus of this book is on helping managers learn how to do this.) Although at the surface, the specific tax rules relevant to a decision may be unclear, uncertain, and changeable, there is a deep structure to taxation worldwide. Knowing the structure helps in posing the right questions to the right sources—be they tax experts or tax information Web sites—and understanding the answers found. The following section outlines the deep structure of taxation and tax planning.

Goals of an Ideal Taxing System

The basic objective of taxation is to raise revenues to finance governments. Governments also attempt to achieve other objectives in designing and implementing tax systems. These objectives are frequently complicated by the dynamics of political, economic, and social forces. Since the writings of 18th-century economist Adam Smith, people designing tax systems have often considered the criteria he identified: *equality, certainty, convenience,* and *economy.*

Equality means that taxpayers should bear a fair level of tax relative to their economic positions (e.g., income, for income taxes). Equality can be defined in terms of horizontal and vertical equity. Horizontal equity means that two similarly situated taxpayers are taxed the same. Vertical equity means that when taxpayers are in different economic positions, the taxpayer with the greatest ability to pay, pays the most in taxes. For the most part, federal, state, and foreign income taxes attempt to adhere to horizontal equity, both in the taxation of individuals and corporations. Vertical

equity is prevalent in individual income taxes, but less so in business taxes. (See Examples, 1.19, 1.20, and 1.21.)

EXAMPLE 1.19

Bill's income for the year consists solely of $15,000 in dividends. Ted's income consists solely of $15,000 in interest income. Both pay a tax rate of 15%, or $2,250 in taxes; there is horizontal equity.

EXAMPLE 1.20

X Corporation has net income from the sales of widgets of $15,000. *Y* Corporation has net income of $15,000 from the performance of services. Both pay a tax of $2,250; there is horizontal equity.

EXAMPLE 1.21

Refer back to Example 1.19. Assume, in addition to the $15,000 of income, Bill has an additional $45,000 of dividend income, giving him a total of $60,000 in income. If he is still taxed a 15% rate, there is no vertical equity; if he is taxed a higher rate (say, 25%) there may be vertical equity, since Bill pays proportionately more taxes than Ted.

Most income taxes are progressive. That is, higher tax rates apply when there are higher levels of the amount being taxed. For income taxes, this amount—called the *tax base*—is taxable income. However, consumption-related taxes (such as VAT) are rarely progressive (and are often considered regressive) because there is typically only one tax rate. For example, consider sales and use taxes. These are usually paid to states and localities by consumers of tangible goods. Because poor people spend much more of their incomes on consumption than do rich people, they pay proportionately more of their incomes on sales and use taxes.

Certainty means that a taxpayer knows when, how, and how much tax is paid. People in the United States generally know that the balance of their income taxes for a year is due on the following April 15, and that taxes will be withheld from their paychecks. Similarly, corporations know that their income and payroll taxes are due quarterly.

Convenience means that the taxes should be levied at the time it is most likely to be convenient for the taxpayer to make the payment. This generally occurs as they receive income because this is when they are most likely to have the ability to pay. Another aspect of convenience is method of collection. Income taxes in the United States are privately determined by indi-

viduals and businesses, and are self-assessed. In contrast, import, property, sales, use, and other taxes are calculated and assessed either by governments or (for sales, use, and value-adding taxes) by vendors.

Economy means that a tax should have minimum compliance and administrative costs. That is, it should require a minimum of time and effort for the taxpayer to calculate and pay the tax. Administrative costs are expenses incurred by the government to collect the tax. Compliance and administrative costs are highest for income taxes, because of their complexity.

Tax Rates and Structures

Taxes are computed by multiplying the tax rate by the tax base, that is, tax rate × tax base = tax. The tax base is the amount that is subject to tax. For income taxes, the tax base is taxable income, defined roughly as income less allowable expenses. For property taxes, the tax base is some measure of the value of the property. Consumption taxes, such as VAT and sales tax, are most often based on the sales price of the merchandise sold. For payroll taxes, a common tax base is compensation.

Tax Rates For most taxes there are three types of tax rates: *marginal, average,* and *effective* rates. The marginal rate is the tax rate that will be paid on the next dollar of tax base (i.e., the rate on the next dollar of income for income taxes, or the rate of tax that will be saved on the next dollar of deduction). (See Example 1.22.)

EXAMPLE 1.22

At the end of the year, XYZ Corporation has taxable income of $50,000. Its tax rate is 15%, so it pays a tax of $7500. Suppose it sells some inventory on the last day of the year for a net gain of $20,000. The gain would put the corporation in the 25% bracket. Thus, the marginal rate on this income is 25%.

The average rate is computed as the total tax divided by the total tax base. The average tax rate in Example 1.22 is ($7,500 + $5,000) / $70,000 = 17.9%. The effective tax rate is total taxes divided by economic income. (Because it includes amounts not resulting from actual transactions—like the rent saved by owning a home—economic income is typically estimated.) For corporations, the effective tax rate generally uses financial-accounting income as the denominator. Suppose the corporation in Example 1.22 has financial accounting earnings of $100,000. Its effective tax rate is ($7500 + $5000)/$100,000 = 12.5%.

How is the effective rate important? The further the firm's effective rate is below the statutory rate, the better a job it is doing in managing its taxes.

Tax Rate Structures Tax rate structures can be thought of as being *proportional, progressive,* or *regressive*. With a proportional (or flat) tax rate, the average rate remains the same as the tax base increases. Other than the income tax, most taxes are proportional. For example, suppose a county charges a 1% property tax on the assessed (fair market) value of property owned. Whether the corporation owns $100,000 or $100 million worth of property, the rate is still 1% (i.e., it is proportional.)

With a progressive tax rate structure, the average rate increases as the tax base increases. Most income tax systems are progressive. Examples are the U.S. Federal individual and corporate income tax, most state individual income taxes, and many foreign corporate and individual income taxes. Using Example 1.22, there again is a progressive structure. The first $50,000 of taxable income is taxed at 15%; thereafter, the rate is 25%.

A regressive structure is one where the average rate decreases when the base increases. Many people consider sales tax regressive. This is because if the total sales tax paid by a taxpayer is divided by income, the average rate decreases by income. (See Example 1.23.)

EXAMPLE 1.23

Tom earns $100,000 per year. He spends $20,000 of this on clothing and other consumer goods, which are subject to a 7% sales tax. Jerry earns $50,000 and spends the same amount on the same items. Thus, both pay $1,400 in sales taxes. Jerry's rate is $1,400/$50,000 or 2.8%; Tom's is $1,400/$100,000 or 1.4%. Thus, this tax is regressive by income.

SOURCES OF TAX LAWS

People who want to learn tax rules consult two basic types of sources. These are primary sources and secondary sources. Appendix A provides more information on how to do tax research. Primary sources are the official governmental pronouncements on the subject. For U.S. income taxation, for example, primary sources include statutes enacted by Congress (such as those embodied in the Internal Revenue Code), regulations and rulings issued by the IRS, and judicial opinions in court cases dealing with tax matters. Primary sources should be consulted (either directly or through a tax specialist) when makeing important decisions. Although more precise and authoritative than secondary sources of tax law, primary sources can be extremely difficult to understand.

Secondary sources of tax rules are easier to understand and most useful when learning about something for the first time. These are summarized versions of the official tax rules. Secondary sources include the numerous commentaries on tax issues found in newspapers, such as the Wednesday front page tax column of *The Wall Street Journal.* Also included are the multitude of articles found in professional tax journals and treatises published by eminent tax professors, tax practitioners, and their associations, such as the American Bar Association for lawyers and CPA societies for accountants.

As with U.S. federal tax rules, there are legislative, judicial, and administrative primary sources of tax law for most jurisdictions such as states like New York and countries like Singapore. The nature and scope of these varies with the structure of the laws and government. Secondary sources are available, too, for most jurisdictions, but tend to be less useful, and less available, than those for the U.S. government.

To find secondary sources, go to *www.taxsites.com* and click on "Help-Tips-Articles." The Big Four accounting firms and the large international law firms also publish a great deal of excellent tax and tax-related literature both in print and in electronic form through their Web sites. These sources are particularly useful when learning about the basics of taxation in a foreign country. In addition, there are extensive commercial publications devoted to indexing and explaining tax rules worldwide. These, too, are available both in print and electronically. (For example, go to *www.taxsites.com* and click on "Tax Software.")

Secondary sources like these tend to be arranged in two basic ways. The first, called "tax services," are organized like encyclopedias. They are arranged topically. Tax concepts are presented in editorial style and cross-referenced to primary sources through footnotes, much like a very big textbook. For example, for U.S. income tax rules, a tax service might have a 50-page discussion on the various aspects of taxing capital gains. This would be indexed with footnotes citing primary sources like Internal Revenue Code sections, Treasury Regulations, IRS Rulings, or opinions of the U.S. Supreme Court, circuit courts of appeals, or trial courts.

The second approach, called "annotated reporters," is more like a dictionary than an encyclopedia. Annotated reporters are organized around official pronouncements. In the United States, they usually are organized around Internal Revenue Code sections in numerical order. First, the text of a section is presented, along with a brief history of its legislative changes over the years. Following this would be the text of all of the official regulations duly issued by the IRS, under this code section. Each regulation is followed by short—most often only one sentence—summaries of relevant IRS rulings and judicial opinions. Brief editorial commentary appears throughout. In this way, annotated reporters provide a road map to the primary sources of law.

Legislative Sources

Unlike most accounting rules, those for taxation usually result from an explicitly political process. Tax rules result from a complex interaction of a variety of official and unofficial actions taken (or not taken) at different times. For U.S. taxes, for example, officials of all three branches of the Federal government, the legislative (Congress), executive (president), and the judicial (courts), are involved. There are five basic official actions during the progress of federal tax legislation in Congress that generate primary sources of law. The U.S. Constitution requires that federal income tax legislation originate in the House of Representatives. Technically, only a representative may commence the federal tax legislative process, doing so by depositing a bill in the Speaker's hopper. Under current rules, the bill is forwarded to the House Ways and Means Committee (unless the House Rules Committee decides otherwise, an extremely rare event). When this committee receives a bill, it (in actuality, the committee's chairperson) determines whether to proceed. Texts of bills can be found in a variety of places, such as the *Congressional Record.*

If a bill is viable, the Ways and Means Committee schedules public hearings. Traditionally a delegate from the secretary of the treasury's office is the first person to testify, although usually the testimony is merely a recital of a written statement. Following common practice, this is referred to as the secretary of the treasury's testimony even though it is almost always delegated to an assistant such as an undersecretary. The testimony largely consists of reading a carefully prepared paper—it is the text of this paper (which can be edited after the fact) that is printed in the *Congressional Record*—not a transcript of the words actually spoken. This statement is available immediately on news services, such as the *Dow Jones News Wire;* electronic databases, such as *Dialog;* and tax information services, such as BNA's *Daily Tax Reports.*

Because of the presidential veto power, U.S. tax professionals generally view the secretary of the treasury's testimony as the first key indicator of the viability and ultimate provisions of the legislation. So do the capital markets. This is not surprising, because for most U.S. tax legislation since World War II, the secretary's testimony has largely indicated the eventual provisions actually enacted.

After the public hearings close, the Ways and Means staff (almost always in concert with the staffs of the Joint Committee on Income Taxation and the IRS chief counsel's legislative division) rewrite the bill to reflect the committee's desires. The most important reason for this is that (unless the House Rules Committee overrides long-standing practice) no tax legislation reaches the House floor unless passed (by a majority vote) out of Ways and Means (and no amendments can be made on the House floor). The language

of the Ways and Means' bill is considered by many tax professionals to be the most telling indicator of eventual federal tax legislation. It is so important that Ways and Means publishes a report (akin to a college textbook, replete with examples and rationales) when it passes a bill. Because the committee votes and issues the report concurrently, the release of the report is a key informational event, and reading the report is a top priority among senior tax professionals in the United States.

The U.S. Constitution also provides that to become law a bill identical to that passed by the House also must be passed by the Senate. Senate bills follow the same pattern as in the House. Senate rules give the Senate Finance Committee jurisdiction. It holds hearings with the secretary of the treasury testifying first. This testimony usually merely regurgitates the House testimony. Like the House committee, the Senate tax-writing committee issues a report when it passes the bill to the Senate floor.

There are two main differences between the processes in the Senate and the House. First, the Senate allows floor amendments after passage out of committee. Senators proposing amendments can document their rationale by inserting a statement into the *Congressional Record*. Such a statement would serve the same function as a committee report as an official source for legislative intent. Floor amendments are rare. More important, the Senate is largely a reactive body—it amends the House Bill—rather than a proactive body—it usually does not create new provisions. Thus, although senior tax professionals pounce on the Senate Finance Committee's report, few surprises are found in most legislation.

Two more steps are involved, however. Unless the House and Senate bills are identical—and they rarely, if ever, are—the bills are sent to a conference committee. Half of its members are representatives and the other half senators; no hearings are held, but a report is issued. A compromise bill then goes back to both houses whereupon, if passed by both, it goes to the president for signature (as with the 1993 Act) or to be vetoed (as with the 1992 Act). Few surprises are expected, or actually occur here. But, as with the 1992 Act, the last-minute logrolling that characterizes conference committees as a whole creates a potential for surprises.

After a bill is passed by both houses of Congress, it is sent to the president, who can either sign the legislation or veto it. (The president cannot veto just part of a bill; there is no line-item veto on tax legislation.) If the president vetoes a bill, it can still become law if upon resubmission to Congress two-thirds of the senators and two-thirds of the representatives vote for the legislation. Neither action results in a report or other official documentation of great use in determining tax rules. Similarly, no official reports interpreting the legislation are issued by the president. Bills that are enacted are published *verbatim* in *Statutes at Large*. There is one last report, however.

Congress has a standing committee that oversees tax policy but is not directly involved in individual bills. Significant new tax legislation is often the subject of many articles and conferences by tax professionals. After about six months of this scrutiny, the staff of the Congress's Joint Committee on Income Taxation may issue a report answering some of the questions raised. This committee is not involved in passing particular legislation, but is a standing committee devoted to long-range considerations. The report is called the *Blue Book,* and is widely consulted by tax practitioners seeking to understand new tax laws. The *Blue Book* summarizes the wisdom of the staff, and reflects the flurry of commentary by tax professionals in conferences and journals that results after new legislation is enacted. One of the most useful features of this report is the numerous examples it usually contains.

For convenience, most U.S. statutes are organized into codes, with legislation usually consisting of amendments to the relevant code. Almost all legislative law changes are inserted into the relevant code, which presents federal law in a highly structured, organized, and stylized manner. For example, most tax legislation is embodied in Title 26 of the United States Code. Codes organize rules topically, with those dealing with similar issues bundled together. Codes have a very logical structure. The basic unit is the code section. Code sections are divided into pieces—subsections, paragraphs, subparagraphs, clauses, and subclauses—and grouped into larger bodies—subchapters, chapters, subparts, parts, subtitles, and titles.

Administrative and Judicial Sources

The administrative agency in charge of enforcing tax rules often issues a variety of rules to guide taxpayers. In the United States, this agency is the IRS. It issues primary sources of law in its weekly publication, the *Internal Revenue Bulletin,* ranging from simple announcements and notices to more detailed rulings (which present rules in a story format) and highly stylized regulations (which present rules much like code sections, except that there are usually more examples given). Tax regulations themselves are codified in the U.S. Code of Federal Regulations, and are referenced by the primary Internal Revenue Code section to which they relate.

A branch of the Department of the Treasury, the IRS shapes tax laws in two basic ways. First, it enforces the laws by choosing the tax returns to audit and the parts of these returns to challenge. More important, however, is that the IRS issues guidance on what the tax rules are. This is done through a variety of publications and official pronouncements. Current publications and pronouncements can readily be found on the IRS Web site. The most authoritative of these are Treasury Regulations, which are official interpretations of specific Internal Revenue Code sections. Indeed, regula-

tions often read much like code sections, except that sometimes there are examples illustrating what the text means. Occasionally, regulations are written in question-and-answer format.

The IRS also issues a variety of rulings, the most common of which are Revenue Rulings. Unlike regulations and code sections, rulings present the IRS's official analysis of cases. First, a fact pattern is presented. Then, an issue is spotted. Next, the issue is analyzed. Finally, a conclusion is stated and supported by citations to primary sources. Rulings are vignettes, much like parables, which the IRS uses to guide taxpayers by showing how it believes the tax rules apply to a standard fact pattern. The IRS also issues other rulings, such as Private Letter Rulings, where it provides the same kind of analysis at a taxpayer's request, for a specific proposed transaction.

As already noted, the IRS also enforces U.S. tax rules by scientifically selecting a few—on average less than 1% annually—tax returns every year to analyze in a tax audit. Disputes arising from audits can be settled during the audit or after the audit through an appeal to a special branch of the IRS devoted to this function. Disputes not resolved in this way can be—although due to cost they rarely are—submitted to the Judicial branch of government, that is, the federal court system.

Judicial sources of law comprise the opinions written by judges dealing with tax disputes that are not settled administratively. Cases start in one of the three trial courts. Taxpayers usually select U.S. tax court, but sometimes choose their local district courts or the U.S. Court of Federal Claims located in Washington, DC. There is an art to forum shopping, that is, choosing the best court in which to try a case, based on factors such as cost, whether a jury trial is available, and the different precedents that govern a particular court. Trial courts are where factual issues are determined. In deciding the case, however, the court also must determine what the applicable rules of law are and how to apply them to the facts of each case. A written judicial opinion typically results. These present the facts, cite the relevant laws, and explain the decision, and can be found via commercial tax services or via the Web (again, it is easiest to find them by starting with a gateway Web site).

If the outcome here is unsatisfactory, the next step is the U.S. Court of Appeals. Appeals courts can reverse trial courts, but only where the rules of law were not properly applied. A very small percentage of cases decided by trial courts are further litigated in U.S. Courts of Appeal. These courts analyze the rules of law applied by trial courts for errors, but do not redetermine what the facts are. Finally, the taxpayer can attempt to go to the U.S. Supreme Court, although tax cases are rarely heard by the high Court. Less than a handful are decided every year by the Supreme Court, the opinions of which become the law of the land. With some exceptions, each of

these courts issues its decisions in the form of written opinions, which form precedents that bind future court decisions on similar issues.

IMPORTANT PRINCIPLES AND CONCEPTS IN TAX LAW

This multifaceted system of tax rules may seem bewildering at first. However, most tax systems have developed around fundamental concepts that do not change much and thus provide a deep structure to tax rules. For example, a number of principles and concepts guide how tax laws are structured in the United States. While they cannot be used to provide guidance on all tax rules, they generally explain why many tax laws are structured the way they are throughout the world.

Ability-to-Pay Principle

Under the ability-to-pay principle, the tax is based on what a taxpayer can afford to pay. One concept that results from this is that taxpayers are generally taxed on their *net* incomes. (See Example 1.24.)

EXAMPLE 1.24

X and Y corporations each have sales revenues of $500,000. Expenses for the two corporations are $100,000 and $300,000, respectively. Corporation X will pay more taxes, because it has greater net income and cash flows, and thus can afford to pay more.

This concept does not apply to every tax in every jurisdiction. Nor do the rest of the concepts presented in this section. Furthermore, those that do most often are understood rather than explicit. That is, they are unofficially applied administratively rather than mandated by primary sources of law. These concepts are more likely to have developed in more industrialized societies where tax laws have become more complex, the foremost example being the United States. Nevertheless, by suggesting what the tax rules ought to be, these concepts can help people understand current rules and anticipate what the rules will most likely be in the future.

Entity Principle

Under the entity principle, an entity (such as a corporation) and its owners (for a corporation, its shareholders) are separate legal entities. As such, the operations, record keeping, and taxable incomes of the entity and its owners (or affiliates) are separate. (See Example 1.25.)

EXAMPLE 1.25

An entrepreneur forms a corporation that develops and sells the entrepreneur's software products. During the year, the corporation has $200,000 in revenue and $50,000 in expenses. The entrepreneur also has a salary of $100,000. The corporation will file a corporate tax return showing $50,000 in taxable income, and the entrepreneur will file an individual tax return showing $100,000 of income.

Closely related to the entity concept is the arm's length doctrine. *Doctrines* are principles that, while often not officially appearing in the tax laws, carry the weight of law. In the United States, for example, doctrines are developed through a series of court cases. An *arm's length transaction* is one in which all the parties in the transaction have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. Transactions that are not made at arm's length will not be given their intended tax effect. (See Example 1.26.)

EXAMPLE 1.26

Assume that in Example 1.25 the corporation pays its entire $250,000 in net income to the entrepreneur as a salary for being president of the corporation. Suppose that a reasonable salary for a president of a small software company is $100,000. The effect of the salary is to reduce the corporation's taxable income to zero, so that it does not have to pay any taxes. While salaries in such closely held corporations are deductible in general, in this case the arm's length test is not met. As a result, only $100,000 (i.e., the reasonable portion) of the salary will be deductible by the corporation. The remaining $150,000 will be considered a dividend.

In determining whether the arm's length rule is likely to be violated with regard to expenses and losses, tax authorities look to see if the transaction is between related taxpayers. Related taxpayers generally include individuals related by blood and marriage, and business entities owned more than 50% by a single entity or individual. (See Example 1.27.)

EXAMPLE 1.27

Assume that an entrepreneur sells an asset to his corporation, and that the sale results in a loss. The entrepreneur owns 49% of the corporation's stock; the other 51% is owned by a group of unrelated investors. Since the loss is not between related taxpayers, it may be considered arm's length.

In applying the ownership test, *constructive ownership* is considered. That is, indirect ownership and chained ownership are considered. (See Example 1.28.)

EXAMPLE 1.28

Assume the same facts as Example 1.27, except that the other 51% of the stock is owned by Z Corporation, which is owned 100% by the entrepreneur. By the rules of attribution and constructive ownership, the entrepreneur is considered to own 100% of the stock: by direct ownership in the first corporation, plus the stock owned by the Z Corporation. Thus, the transaction is not arm's length, and none of the loss would be deductible.

Pay-As-You-Go Concept

Related to the ability-to-pay concept is the pay-as-you-go concept. Taxpayers must pay part of their estimated annual tax liability throughout the year, or else they will be assessed penalties and interest. For individuals, the most common example is income tax withholding. In the United States, for example, employers withhold estimated income taxes and payroll taxes from each employee's paycheck, and then remit the withholding to the government. These taxes, and the requirements for withholding, can be imposed by local governments (such as cities) as well as higher levels (such as state and national governments), but are more common of the higher levels.

In many countries, the withholding *is* the tax; in the United States, it is only a prepayment, which is reflected as a credit against further liability when the relevant tax return for the period is filed. If the taxpayer also has nonwage income (that is, income not subject to withholding), the taxpayer must remit one-fourth of the estimated annual tax due on this nonwage income every three months. This estimated tax requirement generally applies only to expected taxes over a minimum level, such as $1,000 for annual U.S. personal income tax. (See Example 1.29.)

EXAMPLE 1.29

Referring to Example 1.26, how should the entrepreneur pay U.S. income taxes on personal income from the corporation? The $100,000 salary portion must have taxes withheld by the employer (the entrepreneur's own corporation). In addition, the entrepreneur is supposed to pay taxes on the $150,000 dividend every three months prior to actually receiving the dividends at the end of the year. If these estimated taxes are not paid in advance, the taxpayer will be subject to penalties and interest.

Under the same pay-as-you-go principle, corporations in the United States (which typically do not have taxes withheld) must remit one-fourth of their estimated annual tax every three months by making estimated tax payments. (See Example 1.30.)

EXAMPLE 1.30

Suppose a corporation expects to owe $200,000 in taxes at the end of the year: $160,000 in U.S. federal income taxes, and $40,000 in state income taxes. It is required to prepay $40,000 and $10,000 to the federal and state governments, respectively, every three months, or else be subject to penalties and interest.

All-Inclusive Income Principle

This principle basically means that if some simple tests are met, then receipt of some economic benefit will be taxed as *recognized* income, unless there is a tax law specifically exempting it from taxation. The tests are as follows (each test must be met if an item is considered to be income):

- Does it seem like income?
- Is there a transaction with another entity?
- Is there an increase in wealth?

The first is a commonsense test meant to eliminate things that cannot be income. For example, making an expenditure cannot generate income. The second test is the *realization* principle from accounting; that is, for income to be recognized, there must be a measurable transaction with another entity. Therefore, accretion in wealth cannot generate income. (See Example 1.31.)

EXAMPLE 1.31

A corporation owns two assets that have gone up in value. It owns common stock in another corporation, which it originally purchased for $100,000 and is now worth $500,000. It also owns raw land worth $1 million, which it originally purchased for $200,000. It sells the stock for its fair market value, but not the land. Income is recognized only on the stock; there has been no realization on the land.

The increase-in-wealth test means that unless there is a change in net wealth, no income will be recognized. This eliminates a number of transactions from taxation. (See Example 1.32.)

EXAMPLE 1.32

A corporation borrows $5 million from a bank, issues $1 million in common stock, and floats a bond issue for which it receives $10 million. Although each of these transactions involves cash inflows and transactions with other entities, there is no change in net wealth. This because for each of the three cash inflows, there is an offsetting increase in liabilities (or equity) payable.

Closely related to the income-realization concept are the concepts of *recovery of capital, claim of right,* and *constructive receipt*. Under recovery of capital, a taxpayer does not usually recognize income on the sale of an asset until the taxpayer's capital is first recovered. Under claim of right, income is recognized once the taxpayer has a legal right to the income. Under constructive receipt, income is recognized when it is available for the taxpayer's use, even if the taxpayer does not collect the income. Note that constructive receipt applies only to cash-basis taxpayers; accrual-basis taxpayers recognize income (if it is realized) regardless of whether it is received. (See Example 1.33.)

EXAMPLE 1.33

A corporation sells inventory for $100,000; its cost to manufacture is $10,000. The sale is for cash. It also receives $100,000 from a customer by mistake; it will eventually have to pay the money back. Finally, it makes another cash sale of inventory for $10,000, with a cost of goods sold of $2,000. The sale was at year-end. The corporation did not pick up the check from the client until the beginning of the next year, even though the money was available to it before year-end.

Under recovery of capital, on the first inventory sale, the corporation is first allowed to recover its $10,000 inventory cost; only the remaining $90,000 is subject to tax. On the second item, there is no income because there is no legal claim of right to the funds; they will legally have to be returned. Finally, the disposition of the last item (constructive receipt) depends on the corporation's method of accounting. If it is an accrual-basis taxpayer, when it receives the cash is irrelevant; income is recognized at the time of the sale. If it is a cash-method taxpayer, constructive receipt occurs this year, since the funds are available.

Note that the concept of recovery of capital also implies that if the taxpayer does not dispose of the asset, the taxpayer can recover the tax basis over time through depreciation. The extant depreciation used, for federal income tax purposes, is the modified cost recovery system (MACRS), discussed later in the chapter. With only minor exceptions, a capital expenditure cannot be expensed but instead must be depreciated over time.

Legislative Grace

Closely related to the income concepts already described is the concept of *legislative grace*. Here, income that would normally be taxed under the preceding rules is either exempt from tax or subject to a lower tax rate due to special rules. In the United States, for example, these can be provisions in the law, such as the Internal Revenue Code enacted by Congress or its equivalent at the state level. For all taxpayers, one example is the federal exclusion of interest income from state and local obligations. For corporations, federal income tax law has a number of exclusions, the most noteworthy being

- Exclusion from U.S. taxation of the income of subsidiaries located overseas until the funds are repatriated (this applies for most, but not all, subsidiaries)
- Exclusion of up to 100% of dividend income received from another corporation

For individuals, there are numerous exclusions related to employment (some fringe benefits, insurance, retirement fund contributions), illness or death (workers' compensation benefits or life insurance proceeds), family transfers (receipt of gifts and inheritances), and education (scholarships, fellowships, and some employee tuition-assistance plans). Perhaps the most significant is the preferential tax rates given to long-term capital gains. The standard U.S. tax rate is 20% on long-term capital gains, a rate substantially below the maximum federal rate of 39%. This rate can be even lower: For individuals who are in the 15% bracket for ordinary income, a 10% rate applies to long-term capital gains. In many countries, gains from the sale of long-held assets are exempt from taxation.

An important aspect of the preferential capital gain tax rate as related to strategic tax planning is the owner's or manager's sale of ownership of the entity. (See Example 1.34.)

EXAMPLE 1.34

An entrepreneur sells the stock in his company to a larger firm. He sells the company for $10 million. His tax basis in the stock, or what he put into the company (in return for stock), is $1 million. After subtracting his basis (concept of recovery of capital), his capital gain is $9 million. The maximum tax rate on the gain is 20%.

The legislative grace concept applies to deductions as well (deductions are expenses that can be used to reduce taxable income). In the United States, no deduction is allowed under federal and most state income tax laws unless it is specifically authorized by the law. For businesses and sole pro-

prietors, the usual types of expenses are generally allowed for tax purposes. This is also true for certain types of expenses related to individuals' investment incomes.

However, other deductions for individuals exist purely by legislative grace. For example, as already noted there is a fixed standard deduction. If greater, however, individuals are allowed itemized deductions (bounded by elaborate ceilings and floors) for medical expenses, charitable contributions, state taxes paid, home mortgage interest expense, casualty and theft losses, and certain miscellaneous types of expenses.

Business Purpose Concept

Business purpose is closely related to legislative grace as it relates to deductions. Here, business expenses are deductible only if they have a business purpose, that is, the expenditure is made for some business or economic purpose, and not for tax-avoidance purposes. The test is applied to a bona fide trade or business, or to expenses for the production of income. The former is a sole proprietorship, corporation, or other business entity. The latter generally includes investment-type income of individual investors. This rule is typically enforced only when the business deduction also gives some economic benefit to the owner; thus, the owner is trying to get something of value in after-tax dollars, when the item is not otherwise deductible. The rule is typically enforced only in closely-held businesses. (See Example 1.35.)

EXAMPLE 1.35

An entrepreneur owns 100% of the stock of her corporation. She has the corporation buy an aircraft to facilitate any out-of-town business trips she might make. The entrepreneur, who also happens to enjoy flying as a hobby, rarely makes out-of-town business trips. Since the plane will not really help the business, and there is a tax-avoidance motive (the plane would generate tax-depreciation deductions), there is no business purpose to the aircraft. Accordingly, any expenses related to the aircraft, including depreciation, are nondeductible.

Accounting Methods

As already noted, some general rules apply when a taxpaying entity wants to choose among cash, accrual, or hybrid (part cash, part accrual) methods of accounting. For individuals, the election is made on their first tax return. Virtually every individual elects the cash method. For businesses, two rules apply. The first is that when inventory is a substantial income-producing

factor, inventory (including related sales and cost of goods sold) must be accounted for by the accrual method. Note that this rule still permits the taxpayer to use the cash method for other items of income and expense. The second rule relates to entity type. If the business is a corporation and it has gross receipts in excess of $5 million, it must use the accrual method for all transactions. Aside from the inventory and the entity-type rules, a business is free to choose any method of accounting.

Tax-Benefit Rule

Under the *tax-benefit* rule, if a taxpayer receives a refund of an item for which it previously took a tax deduction (and received a tax benefit), the refund becomes taxable income in the year of receipt. (See Example 1.36.)

EXAMPLE 1.36

A U.S. corporation pays a consulting firm $100,000 for consulting services in one year. Because this is a normal business expense, the corporation takes a tax deduction for $100,000. Early the next year, the consulting firm realizes it has made a billing mistake and refunds $20,000 of the fees. The $20,000 is taxable income to the corporation in second year because it received a tax benefit in the prior year.

Note that the rule applies only to items for which the firm has received a tax benefit. Accordingly, if the firm was in an NOL status in the prior year, or the amount paid was nondeductible (say, a bribe to a lawmaker), the refund would not be taxable income the next year.

Substance over Form

Under the doctrine of *substance over form,* even when the form of a transaction complies with a favorable tax treatment, if the substance of the transaction is the intent to avoid taxes, the form will be ignored, and the transaction recast to reflect its real intent. (See Example 1.37.)

EXAMPLE 1.37

An entrepreneur is the sole stockholder of his corporation. The corporation never pays dividends to the entrepreneur, and instead, each year it pays out 100% of the corporation's net income as a salary to the entrepreneur (who also serves as company's chief executive officer). The doctrine of substance over form empowers tax authorities to tax at least part of the salary as if it were a dividend.

In jurisdictions where substance over form applies, it has quite often been developed in a series of court decisions rather than by explicit legislative action. Examples are cases such as *Gregory v. Helvering* in the United States, *Furniss v. Dawson* in the United Kingdom, and *Regina v. Mitchell* in Canada.

Recovery of Capital and Calculation of Gains and Losses

A fundamental concept, related to the doctrine of recovery of capital, is the idea of *gains and losses*. That is, only the net gain or loss from the sale of property is taxable (or deductible) for income tax purposes in virtually every jurisdiction. Gain or loss is computed as

Amount realized (the value of what is received) –
Adjusted basis of property given = Gain or loss

The adjusted basis of the property given is computed as

Original basis + Capital improvements –
Accumulated depreciation – Other recoveries of investments
(such as write-offs for casualty losses) = Adjusted basis

The original basis usually is the original purchase price. Capital improvements are additions that have an economic life beyond one year. Accumulated depreciation applies only in the case of an asset used in business. (See Example 1.38.)

EXAMPLE 1.38

A corporation buys a factory building for $2 million in 1991. It sold the building for $3 million in the current year. At the time of sale, the building had $600,000 of accumulated depreciation. In 1998, the corporation spent $400,00 on a new roof. The gain is

Amount Realized:		$3,000,000
Adjusted Basis:		
Original basis	$2,000,000	
Add: capital improvements	400,000	
Less: Accumulated Depreciation	<600,000>	
		<1,800,000>
Net Gain		$1,200,000

As already noted, in the United States gains and losses can be capital or ordinary. Capital gains and losses result from the sale of capital assets, which are defined as *any asset other than the following:* inventory, receivables, long-term business fixed asset, and self-constructed assets. All other assets are ordinary and create ordinary gains and losses. As a practical matter, corporations pay the same tax rate (their normal rate) on ordinary and capital gains. However, losses are treated differently for corporations. Ordinary losses are deductible without limit, while net capital losses are not deductible and must be carried back three years, and if still unused, forward five years. (See Example 1.39.)

EXAMPLE 1.39

A corporation sells a machine for $10,000. It had previously bought the machine for $20,000. At the time of sale, it had $6,000 of accumulated depreciation. This results in:

Amount Realized:		$10,000
Less: Adjusted Basis:		
Original basis	20,000	
Less: accumulated depreciation	<6,000>	
		14,000
Ordinary loss		<$ 4,000>

If the corporation is in the 35% bracket, the tax benefit is (.35)($4,000) = $1,400. How would the answer change if instead there was a $4,000 gain? Because it is ordinary, the gain would be taxed at the 35% tax rate for a total tax effect of $4,000(.35) = $1,400 of tax. (See Example 1.40.)

EXAMPLE 1.40

A corporation sells the stock of a subsidiary for $20 million. It originally bought the stock of the subsidiary for $5 million. The difference is a $15 million capital gain, which is taxed at the 35% rate. What if there was a $15 million loss on the sale of the stock? Then, unless the corporation had other capital gains against which to offset the loss, the loss would be carried back three years to offset any possible capital gains in that year.

Multiple gains and losses must be separated into capital versus ordinary. Next, ordinary gains and losses are netted with each other. Separately, capital gains and losses are also netted with each other. Within the capital category, they must be segregated into short term versus long term. As a practical matter, this long- and short-term distinction does not matter for corporations,

since the tax effect is identical. As explained later in the chapter, the distinction does matter for individual taxpayers, since there is a preferential tax rate for long-term capital gains, that is, gains on assets that have been owned by the taxpayer for more than one year. (See Examples 1.41 and 1.42.)

EXAMPLE 1.41

A corporation has the following transactions during the year: a long-term capital gain of $100, a short-term capital loss of $1000, a short-term capital gain of $200, an ordinary loss of $300, and an ordinary gain of $500. The netting process is as follows:

	Ordinary	Capital	
		Short Term	Long Term
	<$200>	<$1,000>	$100
	500	200	—
Net	$300	<$ 800>	$100

The net ordinary income of $300 will be taxed at the 35% rate. The net capital loss of $700 cannot be deducted in the current year, and instead will be carried back three years.

EXAMPLE 1.42

Assume the same facts as Example 1.41, except that the taxpayer is an individual. The ordinary income would be taxed at the taxpayer's top rate. The net capital loss would be deductible at the taxpayer's ordinary rate (individuals can deduct up to $3,000 per year). What if there was a $700 net gain instead? If the gain was attributable to long-term assets, then the preferential long-term capital gains tax rate (see later discussion) would apply. If the net gain was primarily from short-term assets, then it would be taxed at ordinary income tax rates.

SAVANT FRAMEWORK

Just as there is a deep structure to taxation—that is, a set of principles that fundamentally shape tax rules—there is a deep structure to tax planning. In other words, the multitude of seemingly disparate techniques for reducing the tax burden generated by various transactions can be classified into groups of tax strategies. This is done in the SAVANT framework, which is explained in Chapter 2.

The idea of an analytic framework that classifies tax planning techniques is based on the answer to a fundamental question: Why tax plan in the first place? It may seem obvious at first glance, but this is an important question, which is answered differently at different times, for different organizations and in different countries. This is because tax planning requires changing operations, and doing so is not cost free, and the rewards are uncertain. However, optimizing a firm's total tax burden can be important to its success. Examples 1.43 to 1.51 illustrate the cost-benefit tradeoffs of corporate tax planning.

EXAMPLE 1.43

A software company has excess cash and is considering acquiring a firm. Two targets appear attractive. One is a restaurant business holding company, which has historically earned a 15% return on investment and also has $100 million of tax benefits, which could be used by an acquiring firm. The other is a computer software firm with equal returns, but no tax advantages. Although the discounted cash flows appear higher for the first target, becoming a worldwide dominant software producer is not part of its *strategic plan*. Because management has little expertise in restaurants, returns may actually decline after the acquisition, making the software firm, despite the lack of tax advantage, a better choice.

EXAMPLE 1.44

Marketing management of a breakfast cereal company has presented an idea for a new product that, in their estimation, has a 50% chance of success. If it succeeds, it will generate $10 million of posttax profits annually, increased to $15 million by a $5 million tax credit for research and development. The investment in the new product would be $100 million, and the firm's minimum rate of return is 15%. The new product should be rejected because the *adjusted* (for probability) *value-added* is 10%: ($10 million) plus $5 million tax credit, or $10 million, divided by the $100 million investment.

EXAMPLE 1.45

A bank holding company is considering selling off one of its unprofitable subsidiaries. By selling the subsidiary, conglomerate earnings per share would increase from $4 to $5 per share. However, the subsidiary generates annual free cash flows of $1 million (partly as a result of tax-loss benefits) on a $1 million investment. The after-tax *value-added* is significant, so the subsidiary should be kept.

EXAMPLE 1.46

A pharmaceutical company would like to build an assembly plant in the People's Republic of China (PRC), partly because the current tax rate is 5%. However, managers of other Southeast Asian subsidiaries are convinced that, if anything, the tax rate will increase because of political pressures. Management should *anticipate* that the rate will increase and adjust the expected rate of return accordingly.

EXAMPLE 1.47

A small entertainment firm wants to hire a talented manager away from a larger firm. The manager is currently being paid $10 million annually in salary, which is $2 million more than the small firm can afford. The small firm offers $5 million in cash and $5 million in stock options. Because the options are tax-favored, the manager may find the options very attractive. The small firm has used tax benefits to *negotiate*.

EXAMPLE 1.48

An investment bank has approached a firm about recapitalization. The firm currently has $1 million and $2 million in class A and B common stock, respectively, outstanding. The investment bank has advised that by converting the class A to $1 million worth of bonds, the firm could save $200,000 annually because interest paid on the bonds is tax deductible but dividends paid are not deductible. Before accepting the deal, management must determine what transaction costs are involved, for example, how much the investment bank will charge for its services so that it can determine whether the transaction will result in *value-added*.

EXAMPLE 1.49

Toward the end of the year, engineers from the production department of a manufacturer would like to replace old machinery with new machinery. Tax rates are scheduled to increase in the next year. Thus, tax deductions for future depreciation will have more cash value. Accordingly, management *anticipates* the changing tax rates and structures the transaction to acquire the machinery early in the next year.

EXAMPLE 1.50

A construction company is considering a contract to build a warehouse. Construction would take one year and cost $1 million, with expenses payable currently and $1.2 million to be received on completion of the project. Because of tax-accounting rules, both costs and revenues are not recognized until the second year. Management needs to consider, in determining the project's *value-added,* the time value of the cash flows from this project, with cash flows net of taxes having more impact in year one than in year two, and having a greater impact on value-adding.

EXAMPLE 1.51

A management consulting firm owns a building in eventual need of a new roof. Instead of reroofing, the firm repairs a part each year. Repairs are tax deductible, whereas a new roof must be capitalized; the firm has transformed a non-deductible cost into a deductible one.