# Chapter I:1

# An Introduction to Taxation

## Learning Objectives

After studying this chapter, the student should be able to:

1. Discuss the history of taxation in the United States.
2. Describe the three types of tax rate structures.
3. Describe the various types of taxes.
4. Discuss the criteria for a “good” tax structure, the objectives of the federal income tax law, and recent tax reform proposals.
5. Describe the tax entities in the federal income tax system.
6. Identify the various tax law sources and understand their implications for tax practice.
7. Describe the legislative process for the enactment of the tax law.
8. Describe the administrative procedures under the tax law.
9. Describe the components of a tax practice.
10. Understand the importance of computer applications in taxation.

## Areas of Greater Significance

1. For an introductory course in taxation, two of the topics in this chapter should be emphasized. The first topic to be emphasized is the sources of tax law (both primary and secondary). The student should understand that in spite of the black and white rule approach in much of the following material, a tax practitioner may spend a considerable amount of time dealing with issues that are not clear cut.
2. Second, the administration of the tax law should be emphasized. An understanding of how the Internal Revenue Service operates is valuable to each student, even if the only future application is with regard to the student’s own individual tax return.

## Areas of Lesser Significance

In the interest of time, the instructor may determine that the following areas are best covered by student reading, rather than class discussion:

1. History of Taxation in the United States
2. Other Types of Taxes
3. Criteria for a Tax Structure
4. Objectives of the Federal Income Tax Law

## Problem Areas for Students

The following areas may prove especially difficult for students:

1. The relative weight to be given to various governmental interpretations of the tax law (i.e., Treasury Regulations vs. Tax Court cases).
2. The mechanics and thought process in doing tax research. An instructor who will use tax research as a significant pedagogical tool may want to spend considerable time on the topic at this point. It is very difficult for a student to understand tax research without doing tax research. (See Chapter I:15.)

## Highlights of Recent Tax Law Changes

The following items of tax law have changed since the 2019 edition of this chapter:

1. Income levels for all ordinary income and capital gains tax brackets have increased. (See Quick Reference.)
2. The ceiling amount for paying the full amount of payroll taxes has increased to $132,900 ($128,400 in 2018).
3. The unified transfer tax equivalent has increased to $11,400,000 ($11,180,000 in 2018).
4. The standard deduction has increased to $12,200 ($12,000 in 2018) and $24,400 for married filing jointly ($24,000 for 2018).
5. The beginning of the 37% tax bracket for taxable income from trusts has increased to $12,500 ($12,000 in 2018).

## Teaching Tips

1. If you want to teach tax research in the introductory class, it would be best to assign a comprehensive tax research problem to solidify concepts taught in class.
2. When teaching tax law sources, it is important to clarify to the students the relative priority of the many different sources.

## Lecture Outline

### Types of Tax Rate Structures

1. The Structure of Individual Income Tax Rates (Example I:1-1, I:1-2)
   1. Possible tax rate structures are progressive, proportional (flat tax), or regressive. The current federal tax system is progressive (10%-37%).
2. Corporate Tax Rates
   1. The tax rate for regular corporations (C corporations) is flat (21%).
3. Marginal, Average, and Effective Tax Rates for Taxpayers (Example I:1-4, I:1-5)
   1. Marginal tax rates may vary significantly from the nominal schedule rates. For example, even though the nominal maximum individual rate is 37%, the realized marginal rate is higher because of health care taxes.
   2. Because the federal income tax for individuals is progressive, average tax is always below marginal tax.
   3. Effective tax rates are likely the lowest of the three calculations because economic income exceeds taxable income.
4. Determination of Taxable Income and Tax Due
   1. Taxable income for all types of taxpayers is calculated by subtracting allowable exclusions and deductions from total income. The tax or refund due is calculated by subtracting allowable credits and/or prepayments from the gross tax liability resulting from applying applicable tax rates to taxable income.

### Entities in the Federal Income Tax System

1. Taxpaying entities are individuals (Example I:1-13) and C corporations (Example I:1-14). If trusts and estates do not fully distribute their taxable income, they may pay tax.
2. Flow-through entities are sole proprietorships, partnerships (Example I:1-18), S corporations, limited liability companies and limited liability partnerships, and trusts and estates (to the extent that the trust’s or estate’s income is distributed) (Example I:1-23).

### Tax Law Sources (Topic Review I:1-3; Instructor Aid I:1-1)

1. Legislative tax law sources include the Internal Revenue Code and Congressional Committee Reports.
2. Executive (Administrative) tax law sources include proposed, temporary, and final Treasury regulations and IRS revenue rulings, revenue procedures, private letter rulings, technical advice memoranda, and information releases.
3. Judicial tax law sources include various levels of court decisions.

### Enactment of a Tax Law (Table I:1-2)

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

### Administration of the Tax Law and Tax Practice Issues (Instructor Aid I:1-2)

1. Organization of the Internal Revenue Service
   1. Important personnel in the IRS (in descending authority) are the Commissioner of the Internal Revenue, deputy and assistant commissioners, regional commissioners, and district directors.
   2. Unresolved disputes between taxpayers and the IRS may result in litigation. Tax litigation in Tax Court is handled by the office of the Chief Counsel. Tax litigation in a U.S. District Court and the U.S. Claims Court is handled by attorneys in the Department of Justice.
2. Selection of Returns for Audit (Example I:1-25; Question I:1-29)
   1. With the use of computer analysis and professional judgment, taxpayer returns are selected for additional correspondence, office audit, or field audit. Mathematical errors and certain matching problems (e.g., the amount of interest on a Form 1099 received by the IRS does not match the amount of interest reported by the taxpayer) can generally be resolved by correspondence.
   2. In an office audit, the taxpayer is asked to bring documentation to the IRS office to substantiate income, deduction, and/or credit items on the taxpayer’s return. More complex audits are handled by a field audit where the IRS agent goes to the taxpayer’s place of business or to the office of the taxpayer’s tax professional.
   3. Disputes between IRS agents and taxpayers may be resolved with the IRS Appeals Division. While the overall individual audit rate is less than 1%, individuals with relatively large amounts of income and deductions are significantly more likely to be audited. If a return contains a frequently disputed item (e.g., home office deduction), the likelihood of audit also increases.
3. Statute of Limitations (Problem I:1-48)
   1. The normal statute of limitations (i.e., how long the IRS has to examine the return) is three years from the due date of the return (or when the return is actually filed if late). The statute of limitations is extended to six years if more than 25% of gross income is omitted on the return. There is no statute of limitations if the taxpayer committed fraud or failed to file a return.
   2. The applicable statute of limitations may be extended by mutual agreement between the taxpayer and the government. Reticent taxpayers are encouraged to extend the statute of limitations when the alternative is an immediate unfavorable notice of deficiency. These varying lengths of statutes of limitation also cause a record-keeping problem for taxpayers. How can a taxpayer disprove an IRS claim of fraud without keeping tax records indefinitely?
4. Interest and Penalties (Example I:1-27)
   1. Interest and penalties may apply to taxes due and other taxpayer noncompliance. The deductibility of interest paid will be determined under the normal interest deductions rules. Penalties for failure to file, failure to pay, negligence, fraud, etc., are not tax deductible.

### Components of a Tax Practice

1. Tax Compliance and Procedures
   1. The preparation of tax returns remains a major component of most tax practices. Some major firms have a separate department to deal with tax compliance.
2. Tax Research
   1. The tax research process involves determination of the facts, identification of the problem, determination of the best solution and communication to the client. (See Chapter I:15 for an in-depth discussion of tax research.)
3. Tax Planning and Consulting
   1. Much of the tax professional’s value to a client may be in the planning and consulting areas. Minimizing taxes paid and maximizing after-tax cash flows, while accommodating clients’ desires, is a much sought-after commodity in today’s complex tax environment.
4. Financial Planning
   1. Some tax professionals have added financial planning to their list of services offered. Items analyzed include insurance coverage, investment strategies, and retirement planning.

## Court Case Briefs

*Alfred Ficalora v. CIR*, 55 AFTR 2d 85-473, 85-1 USTC & 9103 (2nd Cir., 1984).

In 1980, an employee of the New York telephone company challenged the constitutional authority of Congress and the Tax Court to impose a direct tax on his wages without apportionment to the States. He cited Article I, Section 9, clause 4 of the U.S. Constitution which prohibits a direct tax without apportionment. The taxpayer further relied on the case of *Pollock v. Farmer’s Loan and Trust Co.*, 3 AFTR 2602, 15 S. Ct. 912 (USSC, 1895) which states that a tax on the income from real and personal property was invalid without apportionment.

The Supreme Court in *Pollock*, however, had stated explicitly that a tax on one’s employment was not a direct tax and did not require apportionment. Further, the Sixteenth Amendment to the U.S. Constitution gave Congress the authority to tax income without apportionment. The court found that the taxpayer had ignored the developments in Constitutional law over the last ninety years and upheld the deficiency and penalties assessed against him.

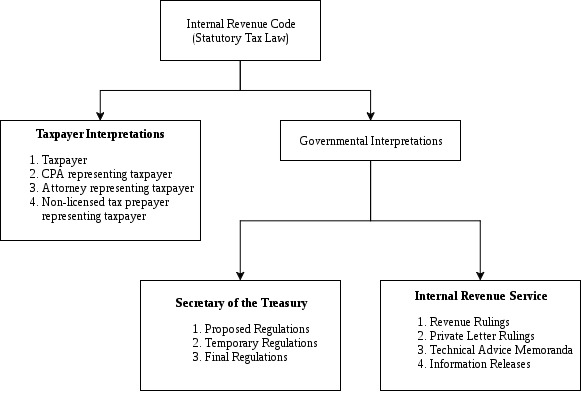
*Walter G. Pietsch v. CIR*, 26 AFTR 2d 70-5847, 70-2 USTC & 9718 (2nd Cir., 1970).

Mr. Pietsch filed his 1968 income tax return, but denied liability for the portion of the tax that was associated with funding the military operation of the United States in the Vietnam conflict. The taxpayer sought a declaration from the court that American participation in Vietnam was unconstitutional and asked the court to enjoin the federal officials from collecting the tax.

The suit was dismissed for failure to state a claim (the taxpayer had not yet paid the tax). The court stated further that Mr. Pietsch was most unlikely to prevail in a refund suit (commenced after the tax was paid) because he did not attack the validity of the tax itself, but rather the use of it.

## Instructor Aid I:1-1

## Tax Law Interpretations



## Instructor Aid I:1-2

## Tax Litigation from the Taxpayer Perspective

