Triads of Income Taxation

As mentioned earlier, income tax rules tend to come in threes. Exposure to these triads of income taxation should help you understand the purpose of the specific income tax rules that are presented in the chapters that follow. In summary, the triads covered here include:

- three types of income
- three types of tax accounting
- three key tax principles
- three components for classifying gain
- three types of assets
- three uses of assets
- three types of rental real estate
- three methods of tax planning
- three anti-abuse provisions
- three types of administrative rulings
- three types of final regulations
- three courts to resolve disputes

Three Types of Income

In the U.S. income tax system, there are three types of income: (1) active (ordinary) income, (2) portfolio income, and (3) passive income. Every bit of income earned by a taxpayer must be classified into one of these three categories.

Active income is income derived from labor, and income connected with the active conduct of a trade or business. Portfolio income is income derived from investments, such as interest, dividends, and capital gains. Passive income is income derived from dealings in real estate and from the conduct of a trade or business in which the taxpayer does not participate.

Categorization of income is important for two reasons: (1) different tax consequences apply to each type of income; and (2) the "bucket rule" limits a taxpayer's ability to write off losses in one income bucket to the gains in that same bucket.

Active income (and loss) is subject to ordinary tax rates, which are the highest tax rates in our system. Some types of portfolio income are subject to favorable tax rates, such as the 15 percent rate that applies to long-term capital gains and qualified dividends. Passive income is subject to a host of anti-abuse rules, and therefore constitutes a separate category of income.

The "bucket rule" limits losses in one bucket to gains in the same bucket. For example, if a taxpayer incurred $5,000 in investment gains and $20,000 in investment losses, $5,000 of the loss could offset the investment gain but could not, under the bucket rule, be used to offset other types of income (such as ordinary or passive income). As in all other areas of tax law, there are exceptions to this rule. In the case of portfolio losses, up to $3,000 of losses in the portfolio bucket can be used to offset either active or passive income. These rules will be discussed more fully in the chapters on the taxation of property transactions.

Three Types of Tax Accounting

For income to be reported properly, taxpayers must follow some method to account for income. There are three methods of accounting that are used for federal income tax purposes: (1) the cash method, (2) the accrual method, and (3) the hybrid method.

The cash method of accounting is the method used by most individuals and small businesses. Under the cash method, income is taxed when it is received, and deductions are claimed when they are paid. Understanding the cash method is particularly important for personal financial planners, who are typically providing financial advice and planning to individuals and small businesses.

The accrual method of accounting is the method frequently used by larger businesses. Under the accrual method of accounting, income is taxed when it is earned (whether or not it has been received), and deductions are claimed when they are incurred (whether or not they have been paid).

Any method of accounting other than the cash method or accrual method that is approved by the IRS is referred to, collectively, as the hybrid method. The hybrid method is used by some businesses to better reflect their economic income on their tax returns

Chapter 3 reviews the methods of tax accounting in more detail, and covers the exceptions to the general rules governing each accounting method listed above.

Three Key Tax Principles

Three key tax principles underlie personal income taxation. They are: (1) the doctrine of constructive receipt, (2) the economic benefit doctrine, and (3) the doctrine of the fruit and the tree.

While most individuals account for their income using the cash method, certain circumstances may arise that will subject income that has not yet been received to current taxation. The doctrine of constructive receipt states that if income is permanently set aside in an account for the benefit of a taxpayer, or if a taxpayer is given the choice to receive income now or defer it to the future, that income will be taxed to the taxpayer currently even if he does not receive it until sometime in the future. For example, consider interest that is earned on a three-year certificate of deposit. Even though a taxpayer does not receive the interest until the certificate of deposit matures, he is taxed on the earned interest currently, since the interest earnings are permanently set aside in an account for the taxpayer's benefit.

The doctrine of constructive receipt is a special exception to the cash-basis method of income tax accounting. In fact, the doctrine of constructive receipt is at the cornerstone of retirement planning, and must be avoided if a taxpayer wishes to defer income and taxes into the future to fund his or her retirement.

You may recall from our discussion above that all income received by a taxpayer, in any form, is subject to income tax. The economic benefit doctrine simply states that if a taxpayer receives an economic benefit as income, the value of that benefit will be subject to tax. For example, if a taxpayer is given group term life insurance by an employer, the value of that group term

insurance is subject to income tax, since it is an economic benefit received in return for labor. Congress has, for public policy reasons, exempted part of the value of group term life insurance from income tax, but excess amounts would be taxable under the economic benefit doctrine.

The third key principal of income taxation is that income is taxed to either, (1) the person who earns it; or (2) the person who owns the asset that produced the income. This principle is referred to as the doctrine of the fruit and the tree. He who owns the tree pays income tax on the fruit that the tree produces. This doctrine is really an anti-abuse provision. It is designed to prevent taxpayers from assigning income to a family member in a lower tax bracket while retaining the asset that produces the income.

Three Components for Classifying Gain

When a piece of property is sold, the manner of taxation will depend on (1) the type of asset that was held; (2) the use to which the asset was put; and (3) the holding period (how long the asset was held). Two of these criteria are specified in their own sections, below. The holding period requirement will be discussed in more detail in Chapter 11 on property transactions.

Three Types of Assets

In the U.S. income tax system, there are only three types of assets: (1) capital assets, (2) ordinary income assets, and (3) IRC Section 1231 assets. To properly determine the tax consequences upon the sale or disposition of a piece of property, the taxpayer must first know what type of property was sold. Each type of asset has different income tax consequences and rules. Depending on the type of asset, different tax rates may apply, or different loss limitation rules may be imposed. The first step that a financial planner should take in determining the tax consequences of a sale of property is to classify the property by its asset type. The rules concerning property transactions are covered in detail in Chapters 11, 12, and 13 of the text.

Three Uses of Assets

Another factor that impacts the tax treatment associated with a sale or disposition of property is how that asset was used by the taxpayer. Individuals can use an asset in three ways: (1) they can use it for personal purposes; (2) they can use it in the active conduct of a trade or business; or (3) they can use it for the production of income. Personal use assets include such things as personal residences, cars, furniture, and the like. Business assets include any assets used in the active conduct of a trade or business, such as machinery, equipment, and real estate. Production of income assets include stocks and bonds held for investment. When attempting to determine the tax consequences resulting from the sale of property, a planner should (1) determine the type of asset, and (2) determine how that asset was used by the taxpayer. The tax rates and loss limitation rules may differ depending on the use to which a taxpayer puts an asset as well as the type of asset that is sold. The rules concerning property transactions are covered in detail in Chapters 11, 12, and 13 of the text.

Three Types of Rental Real Estate

Real estate has always received special attention in both our legal and tax systems. When real estate is held for rental purposes, it is considered production of income property. The tax consequences on the sale of rental real estate, however, will depend on how that rental real estate was used. There are three types of rental real estate activities: (1) tax-free rental activities, (2)

rental use activities, and (3) mixed use activities. The income inclusion and deduction rules differ depending on the use to which the rental real estate was put. The tax rules concerning rental activities are covered in detail in Chapter 8.

Three Methods of Tax Planning

Planners need to know the income tax rules so they can help clients minimize exposure to taxation while achieving their desired goals. There are three primary ways to engage in this type of planning. The planner and client can (1) legally avoid taxation; (2) deduct expenses to reduce taxable income and take tax credits to reduce taxes due; or (3) defer income and thus defer taxation. In addition to these three primary ways to engage in tax planning, two additional methods should be considered. The planner may be able to help clients (4) shift income to related taxpayers in lower tax brackets, or (5) realize income in a form that is taxed at lower tax rates (long-term capital gains or qualified dividends).

Three Anti-Abuse Provisions

While tax planning is useful in assisting taxpayers to minimize their tax liability, too much tax planning could lead to wealthy individuals paying very little tax compared to the rest of the population. Congress has imposed three sets of anti-abuse rules that limit the benefits that can be obtained from tax minimization planning. The three sets of anti-abuse rules are (1) the alternative minimum tax (AMT), (2) the at-risk limitations, and (3) the passive activity rules. The AMT is discussed in Chapter 15, and the at-risk limitations and passive activity loss rules are discussed in Chapter 14. These rules are designed to ensure that everybody pays a fair share of tax on an annual basis.

Three Types of Administrative Rulings

In an attempt to administer the tax system efficiently, and provide taxpayers with information about how to treat various transactions, the Internal Revenue Service issues three types of written rulings: (1) Revenue Rulings, (2) Private Letter Rulings, and (3) Determination Letters. These rulings are important for tax research, and are covered in more depth in Chapter 2.

Three Types of Final Regulations

The Treasury also gives guidance to taxpayers in the form of Treasury Regulations. Once finalized, the Treasury Regulations take one of three forms: (1) Procedural Regulations, (2) Interpretative Regulations, and (3) Legislative Regulations. From a tax-research standpoint, the Treasury Regulations provide a wealth of knowledge about how the statutory law enacted by Congress will be enforced. Some of the regulations constitute law in and of themselves. The types and uses of Treasury Regulations are covered in more depth in Chapter 2.

Three Courts to Resolve Disputes

Sometimes, when the IRS and taxpayer cannot agree on how to treat a certain transaction for income tax purposes, an independent third party is necessary to resolve the dispute. There are three courts that may resolve tax matters: (1) the U.S. Tax Court, (2) the U.S. District Court, and (3) the U.S. Court of Federal Claims. The requirements for bringing a case to the various courts will be discussed in detail in Chapter 2.