



Income Taxation

Income Tax Law Fundamentals

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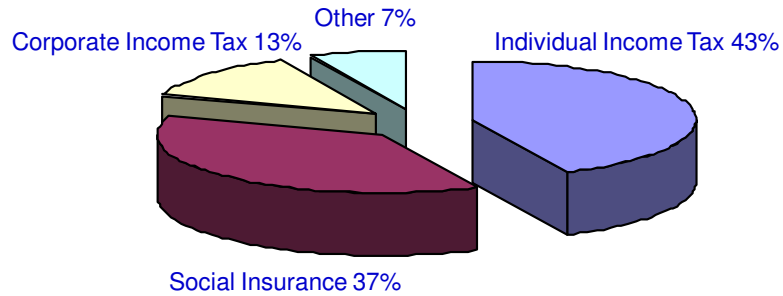
Federal Tax Objectives

- Revenue.
 - Most important objective.
 - Provides resources to fund government expenditures.
- Economic objectives.
 - Taxation is a major tool used to attain economic growth and full employment.
 - Lowering taxes → disposable income → increased demand → economic growth.
- Social objectives.
 - Financial incentives to encourage certain behavior.

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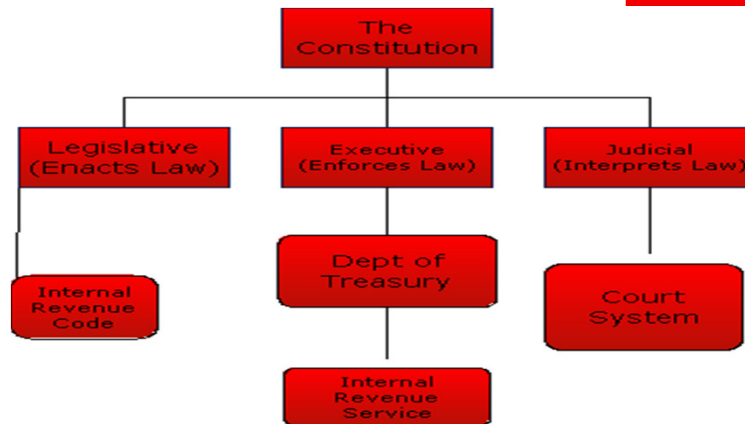
Federal Tax Sources (2005)



Source Congressional Budget Office (<http://www.cbo.gov/ftpdocs/66xx/doc6609/08-15-Slides.pdf>)

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The Internal Revenue Service

- IRS Organization.
 - Part of the Treasury Department.
 - Responsible for administering and enforcing federal tax laws.
 - Issues official interpretations of the tax laws.
 - Four Operating divisions.
 - Wage and Investment Division.
 - Individuals with wage and investment income only.
 - Small Business and Self-Employed Division.
 - Includes partially self employed individuals.
 - Large and Mid-Size Business Division.
 - Tax-Exempt and Government Entities Division.
 - Includes pension plans.

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The Internal Revenue Service

- IRS Organization.
 - Four Functional divisions.
 - Counsel.
 - Provides legal interpretation of internal revenue laws.
 - Appeals.
 - Independent channel for disputes.
 - Taxpayer Advocate.
 - Independent channel for specific taxpayer case problems.
 - Criminal Investigation.

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Income Tax Law Fundamentals

- Sources of Tax Law
 - Primary Sources of Law
 - Actual law generated by a governmental body
 - Secondary Sources of Law
 - Commentaries about the law, not actually law
 - Legal encyclopedias (CCH)
 - Annotations (Universal Citation Guide)
 - Law reviews (SMU Law Review)
 - Dictionaries (Bieber's Dictionary of Legal Citations)

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Income Tax Law Fundamentals

- Primary Sources of Tax Law
 - Congressional Legislation
 - The Internal Revenue Code
 - The United States Courts
 - Supreme Court
 - Court of Federal Claims
 - Tax Court
 - District Court

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Income Tax Law Fundamentals

- Primary Sources of Tax Law
 - Treasury Regulations
 - IRS Rulings and Guidance
 - Revenue Rulings
 - Revenue Procedures
 - Private Letter Rulings
 - Determination Letters
 - Technical Advice Memoranda
 - Announcements
 - Notices

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Income Tax Law Fundamentals

- Codification
 - Arranged all the laws passed by Congress
- United States Code created in 1926
 - Organized into fifty broad subject classifications called Titles
 - Each Title contains all law dealing with a particular subject
 - Title 26 is the Internal Revenue Code

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Primary Sources of Tax Law

- Internal Revenue Code of 1986
 - Highest authority of Tax Law
 - The IRC is normally quoted by code sections
 - Created by Federal Tax Legislation
 - Originated in the House Ways and Means Committee

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Tax Code Citations

- The citation that refers to the disability exception to the 10% premature distribution penalty on qualified plans (*referred to as 72t*)
- TITLE 26
Subtitle A
CHAPTER 1
Subchapter B
PART II
Section 72(t)(2)(A)(ii)
- Is simply written as **IRC§72(t)(2)(A)(ii)**

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Primary Sources of Tax Law

- Treasury Regulations (Regs)
 - Issued by the US Treasury Department
 - IRS is part of the Treasury Department
 - Interpretations of the Code
 - Next highest authority after the Code
 - **Have the full force and effect of law**
 - Provide guidance for new legislation
 - Published in the Federal Register as a Treasury Decision
 - Income tax regs are denoted by a (1.) then the code section
 - The regulation for section 72 would be Reg 1.72

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Primary Sources of Tax Law

- Revenue Rulings
 - Issued by the National Office of the IRS
 - Interpret a specific set of facts
 - Expresses the IRS's views as to the tax results that apply to a specific situation
 - Published to give guidance to IRS auditors and taxpayers
 - Authority
 - **Do NOT have the full force of law**
 - Do not carry the force and effect of Regulations
 - CAN be cited as precedent
 - Rev Rulings are cited by a hyphenated number like Rev Rul 99-28. This means it was the 28th rev ruling in 1998.

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Primary Sources of Tax Law

- Revenue Procedures (Rev Proc)
 - Issued by the National Office of the IRS
 - Official statement of the practices and procedures of the IRS
 - Details requirements to be followed when dealing with the IRS on a particular matter
 - Authority
 - Do not have effect of law
 - Can be cited
 - Published in the Internal Revenue Bulletin
 - Identified similar to Rev Rulings – Rev Proc 2000-01 meaning the 1st Rev Proc in 2001

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Primary Sources of Tax Law

- Private Letter Rulings (PLR)
 - Issued by the National Office of the IRS
 - Ruling as to the tax consequences of a proposed or completed transaction
 - Requested by the taxpayer
 - Applies ONLY to the requester and cannot be cited by anyone else
 - Authority
 - Fully binding on the IRS for that taxpayer
 - Furnished to the general public to provide guidance as to IRS judgment and position

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Primary Sources of Tax Law

- Determination Letters
 - Issued by the District Director
 - Requested by the taxpayer
 - Details the IRS position on a transaction after it has taken place
 - Commonly used to obtain approval on a pension plan that has been established
 - Authority
 - Fully binding on the IRS for that taxpayer
 - Are NOT furnished to the public

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Primary Sources of Tax Law

- Technical Advice Memorandums (TAM)
 - Issued by the National Office of the IRS
 - Requested by an IRS agent to clarify an issue encountered in an audit in progress
 - Details the IRS ruling on a transaction after it has taken place
 - Only applies to the taxpayer whose was being audited

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Summary of Sources

- Kaplan – pgs 2 to 6

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Review

- Which source has the full force and effect of law?
- The annual inflation adjustments are set forth in which source?
- What is the difference between PLR and Determination letters

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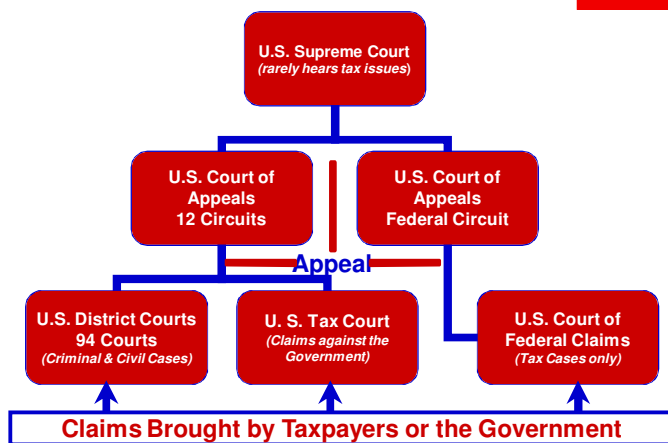
The Judicial Process

- Purpose
 - Resolves disputes between the IRS and taxpayers
- Process
 - Initial trial court hears the case
 - U.S. District Court (94 Courts)
 - U.S. Tax Court
 - U.S. Court of Federal Claims
 - Unresolved disputes can be appealed
 - U.S. Court of Appeals (12 Geographical Circuits)
 - U.S. Court of Appeals (1 Federal Circuit)

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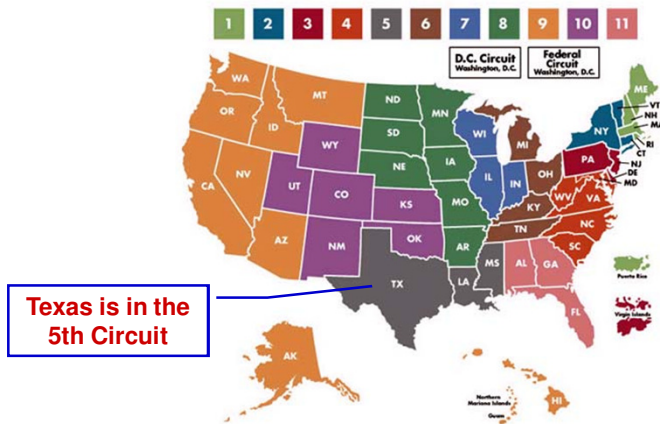
U.S. Federal Court System



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U.S. Federal Circuits



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Judicial Process Chart

- See Kaplan pg 5
- See explanation at Kaplan pg 3, item C

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Tax Compliance

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Income Tax Planning

- Data Collection and Risk Analysis.
 - Tax returns reveal important information. Such as
 - Consistency of risk taking (tax risks vs. other risks e.g. investments).
 - Potential for IRS audit.
 - Clients lifestyle. – limited view
 - What isn't on a Tax Return?

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IRS Audit Process

- Discriminant Index Function System (DIF).
 - A mathematical technique used to classify tax returns as to their examination potential.
 - Returns are weighted based on certain characteristics.
 - Weights are added together to arrive at the total DIF score.
 - Highest scores are manually screened for audit potential.



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IRS Audit Process

- Types of Audits.
 - Correspondence audit.
 - Conducted by written correspondence and telephone contact.
 - Involves simple issues.
 - Office audit.
 - Conducted by tax auditors (less skilled) at the IRS office nearest the taxpayer's home.
 - Involves more complicated issues.
 - Field audit.
 - Conducted by revenue agents (more skilled) at the taxpayer's place of business or where the records are kept.
 - Involves the most complex issues.



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Penalties and Interest

- Failure-to-pay penalty.
 - .5% per month - 25% max.
- Failure-to-file penalty.
 - 5% per month - 25% max.
 - Failure-to-file penalty is reduced by any failure-to-pay penalty.



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Example

- Kaplan pg 185; dialogue on Audit, Penalties and Taxpayer's Rights

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Penalties and Interest

- Accuracy-related penalties.
 - 20% of the portion of the tax underpayment
 - Negligence in preparation, application of tax laws, or keeping proper books and records.
 - If IRS asserts negligence, the taxpayer must prove otherwise.
 - Substantial understatement of tax.
 - Substantial valuation misstatement.



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Penalties and Interest

- Fraud penalties.
 - 75% of the portion of the tax underpayment attributable to the fraud.
 - IRS must prove the alleged fraud.
 - Fraud penalty replaces any accuracy-related penalty (don't pay both).
- Interest.
 - Interest is generally payable whenever any tax or civil penalty is not paid when due.

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Payroll Taxes

- Federal Insurance Contributions Act (FICA)
 - Authorized payroll deductions to fund SSA & Medicare benefits
 - Employer and Employee share the taxes
 - OASDI (Social Security) Tax
 - 6.20% on the wage base (\$102,000 in 2008 \$106,800 in 2009, indexed)
 - HI (Medicare Hospitalization) Tax
 - 1.45% on all income
 - Self-employed persons pay both the employee and employer portions

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Payroll Taxes

- Federal Unemployment Tax Act (FUTA).
 - Provides unemployment compensation.
 - Paid entirely by employers.
 - Most employers pay both federal and state unemployment tax.
 - FUTA tax rate is 6.2%.
 - Applies to the first \$7,000 in wages/employee (\$434 maximum)



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Accounting Methods

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Key Terms

- Tax Avoidance vs Tax Evasion
 - Legal vs. Illegal!
- Fiscal Year vs Calendar Year
 - Fiscal is generally reserved for businesses
 - Can't change without consent of the IRS
- Recognition vs Realization
 - Realized – What happened economically
 - Recognized – Did we recognize it for tax purposes

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Methods of Accounting

- Cash Method
 - Income is reported when constructively received
 - Expenses are deducted when paid
 - Any hybrid or combination method is treated as the cash method
- Accrual Method
 - Income is reported when earned, even if not received until later
 - Expenses are deducted when incurred, even if not yet paid

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Methods of Accounting

- Choice of Accounting Method
 - A taxpayer may choose any accounting method initially
 - Method must reflect taxpayer's income and expenses
 - IRS approval is not needed
 - Must use the selected method consistently year to year
- Change in Accounting Method
 - May change accounting methods only with the permission of the IRS
 - File IRS Form 3115 during the tax year for which the change is requested and pay a user fee

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Cash Method

- Advantages
 - Simple, straightforward and easy to implement
 - Provides some flexibility in accelerating expenses or postponing income to reduce tax liability in a particular year
- Availability
 - Only available to certain entities
 - Individuals and Sole Proprietorships
 - S Corporations
 - Partnerships
 - Small, non farming, C Corporations and Partnerships
 - Personal Service Corporations

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Income Tax Planning

- Data Collection and Risk Analysis.
 - Client Questionnaire should include.
 - Client and family members' names, addresses, dates of birth.
 - Detail of investment assets and retirement plans.
 - Detail of personal residence and rental property.
 - Salaries, bonuses, and other sources of income.
 - Detail of expenses and other deductions for budgeting and income tax.

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