

Taxation

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WAYNE STATE
UNIVERSITY
LAW SCHOOL

Nuts & Bolts

ANNOUNCEMENT OF CLASS RULES

- Regular attendance and class participation expected.
- I reserve the right to adjust grades for class participation or lack thereof.
- Exams on laptops permitted.
- Check the web site for additional information.

<http://www.law.wayne.edu/mcintyre>

Course Materials

AVAILABLE AT BOOKSTORE

Required Texts

Newman, Joel S., *Federal Income Tax Taxation: Cases, Problems, and Materials*, 4th edition ("Casebook") West Publishing Co. (2008).

Selected Sections: Federal Income Tax Code and Regulations (Steven A. Bank and Kirk J. Stark, eds.), Foundation Press, 2009-10 Edition.

Optional Secondary Sources

Chirelstein: *Federal Income Taxation: A Student's Guide*, 11th ed., Foundation Press, 2009.

Joseph Bankman, Thomas D. Griffith, & Katherine Pratt, *Federal Income Tax: Examples & Explanations*, Aspen Publishers, 5th Edition (2008).

Kahn and Kahn's Federal Income Taxation: A Student's Guide to the Internal Revenue Code, 5th Edition, Foundation Press (2005).

Next Class Assignments

PAGE REFERENCES TO CASEBOOK

Sept. 3, 2009: pp. 27-42 (ch. 2)

Sept. 8, 2009: pp. 42-64 (ch. 2, continued)

All assignments include Code and Regulations that are referenced in the casebook

Nature of Taxation Course

GOALS, FEARS, AND ASPIRATIONS

- **Solving Tax Problems.** In some respects, Taxation is like any law course. You learn how to solve legal problems in the subject area.
- **Math Phobia.** To compute taxes, you need to use some basic math skills. But Taxation does not demand high math skills. It is like a math course, however, in that if you get way behind, you have trouble catching up.

Solving Tax Problems

THE BASIC REQUIREMENTS FOR SUCCESS IN TAXATION

- **Analysis.** The key to success in Taxation is to be able to analyze tax problems and find the best available solution.
- **Legal Sources.** The Code and Regulations are detailed and difficult to read, and they are supplemented by thousands of IRS pronouncements and a voluminous case law. You must learn to deal with an overload of legal sources.

Practicing Tax Law

WHAT DO YOU ACTUALLY GET PAID TO DO?

- No one gets top legal fees for solving problems that have already been solved.
- In some cases, the answer is in the Code or other legal sources. But the cases you make money on are the ones that have unsettled answers.
- The Code, etc. provides some points of departure, like points of light in the sky, but you must make the connections.

History of U.S. Taxes

REGRESSIVE EXCISE TAXES TO PROGRESSIVE INCOME TAXES

- Constitution Reserved Import and Export Taxes to Federal government
- First Income Tax Introduced by President Abraham Lincoln to Help Finance the Civil War
- Income Tax Held Unconstitutional in 1895 by Conservative Supreme Court (*Pollack*)
- Corporate Income Tax in 1909
- Personal Income Tax in 1913 (after constitutional amendment)

Goals of Taxation

RAISING REVENUE FOR GOVERNMENT PURPOSES

- Raise revenue necessary to fund government expenditures
 - In short run, surplus or deficit may be used for economic policy reasons
 - In the long term, the revenue must come from taxes, borrowing or printing money.
- Raise the revenue in ways that are fair, efficient, and impose minimum administrative costs.

Fairness in Taxation

WHEN IS A TAX SYSTEM FAIR?

- Traditions goals: horizontal and vertical equity
 - Horizontal equity means treating people in the same circumstances the same
 - Vertical equity means treating people in different circumstances appropriately different
 - Some people conclude that vertical equity requires progressive tax rates.
- Any tax system, to achieve fairness, needs to have some measure of “same circumstances.” One possibility is “income.”

Horizontal Equity

SORTING TAXPAYERS BY INCOME

- To achieve horizontal equity, a tax system requires “sorting rules.”
- Types of Sorting Rules
 - **Tax base rules** — defining taxable income
 - **Taxable person rules** — defining the taxable person or persons and assigning income to the taxable person (family taxation rules)
 - **Taxable period rules** — defining the taxable period (typically the year) and assigning income to that period (tax accounting rules)

Vertical Equity

IMPOSING TAX ON TAXABLE PERSONS

- Tax is imposed on taxable persons with respect to their taxable income for the taxable year.
- Rates and credits are the typical imposition rules
 - Rates may be flat, graduated, or regressive
 - Some deductions, such as the standard deduction, work like a zero tax bracket, providing some degree of progressivity
 - Credits can also provide progressivity

Graduated Rates

U.S. INCOME TAX RATES HAVE ALWAYS BEEN GRADUATED

- **Marginal Tax Rate** — the rate at which additional income is taxed. It is important for economic incentive reasons.
- **Effective Tax Rate** — the average tax rate applicable to the taxpayer's entire income. It is important for fairness.

Income as the Tax Base

MEASURING TAXABLE CAPACITY BY INCOME

- Income is a good measure of taxable capacity
- Other measures would include:
 - Wealth
 - Consumption
 - Wages
- No single measure is complete.
- In general, the tax system is fairer when income is an important part of the tax mix.

Taxing the Poor

HOW TO EXEMPT THE POOR FROM TAXES

- The poor can be exempted from the income tax by having a zero rate on the first major slab of income.
- They could be exempt from the FICA tax by making part of FICA earnings exempt.
- Exempting the poor from a sales tax is very difficult.
- It is trivially easy to exempt the poor from an estate and gift tax/

Tax Expenditure Concept

USING THE TAX SYSTEM TO SPEND MONEY

- Congress and Treasury prepare what is called a Tax Expenditure Budget
- The TEB lists the various tax preferences introduced to influence taxpayer conduct, with an estimate of their cost in forgone revenue
- The idea is that Congress, in considering budget cuts, should also consider cutting programs run through the tax system.

Example of TEB

IDENTIFYING A TAX EXPENDITURE

- Assume that Congress allows a charitable deduction for certain gifts in order to encourage such gifts.
- Tp makes a gift of \$1,000 and takes a deduction for it. She is in the 30% tax bracket, so she saves \$300 ($\$1,000 \times .30$)
- That tax savings is equivalent to collecting the tax of \$300 and making a subsidy payment of \$300 to Tp.