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An Introduction to Tax, Tax Legal Structure and Tax Research

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Textbook: Taxation of Individuals and Business Entities, Spilker



- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Taxation of Individuals and Business Entities, 2017 Ed., Spilker which is the textbook assigned for the course CONT 4076 – “Aspectos Contributivos de Individuos” at the University of Puerto Rico, Río Piedras Campus.



Learning Objectives

- Discuss what constitutes a tax and the general objectives of taxes.
- Describe the different tax rate structures and calculate a tax.
- Identify the various federal, state and local taxes.
- Describe the legislative process as it pertains to taxation.
- Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.

Tax



Tax



1.1 What qualifies as tax?

- A ***Tax*** is a payment required by a government agency that is unrelated to any specific benefit or service received from the government agency.

Tax



1.1 What qualifies as tax?

- Key components of a tax:
 1. Payment required
 2. Payment imposed by government agency (federal, state, local)
 3. Payment not tied directly to benefit received by the taxpayer.

Tax



Example 1:

- Payment of a 10% of salary received (net of allowable deductions).
 - This is a tax.
 - Classification: Income Tax



Tax

Example 2:

- Payment for hotel use of 1% of bill to pay for city projects.
 - This is a tax.
 - Classification: Room Tax



Tax

Example 3:

- Payment for drivers license.
 - **This is not a tax.**
 - **Payment for service received.**



Tax

Example 4:

- Payment for rental car use of 3% of bill to pay for the roads.
 - **This is a tax.**
 - **Similar Example: “La Crudita” or gas tax.**

Tax Calculation





Tax Calculation

1.2 Component of Formula

- To calculate a tax, a taxpayer must know:
 - **Tax Rate:** level of taxes imposed on the tax base and is usually expressed as a percentage.
 - **Tax Base:** defines what is actually taxed and is usually expressed in monetary terms.

$$\text{Tax} = \text{Tax Base} * \text{Tax Rate}$$



Tax Calculation

Example 5:

- The hotel room cost is \$100 per night. The room tax is 8%.
 - **Tax Rate:** 8%.
 - **Tax Base:** \$100

$$\text{Tax} = \$100 * 8\%$$

$$\text{Tax} = \$8$$

$$\text{Total hotel room charge} = \$108$$



Tax Calculation

Example 6:

- John and Mary (taxpayers), file a joint tax return. Their taxable income is \$50,000 for 2017.
- The income tax is computed using the 2017 Federal Married Filing Jointly Tax Rate Schedule.



Tax Calculation

Example 6

- 2017 Federal Married Filing Jointly Tax Rate Schedule:

Married Filing Jointly or Qualifying Widow(er)

Taxable Income	Tax Rate
\$0 - \$18,650	10%
\$18,651 - \$75,900	\$1,865 plus 15% of the amount over \$18,650
\$75,901 - \$153,100	\$10,452.50 plus 25% of the amount over \$75,900
\$153,101 - \$233,350	\$29,752.50 plus 28% of the amount over \$153,100
\$233,351 - \$416,700	\$52,222.50 plus 33% of the amount over \$233,350
\$416,701 - \$470,700	\$112,728 plus 35% of the amount over \$416,700
\$470,701 or more	\$131,628 plus 39.6% of the amount over \$470,700



Tax Calculation

Example 6:

- John and Mary (taxpayers), file a joint tax return. Their taxable income is \$50,000 for 2017.
- The income tax for the taxable year 2017:
 - \$ 50,000
 - - 18,650 \$1,865
 - \$ 31,350 * 15% = 4,702

 - **TAX** **\$ 6,567**

Measure Tax Rates





Measure Tax Rates

1.3 Average Tax Rate:

- The taxpayer's average level of taxation on each dollar of **taxable income**.



Measure Tax Rates

1.4 Effective Tax Rate:

- The taxpayer's average rate of taxation on each dollar of total income (both taxable and non-taxable)



Measure Tax Rates

Example 7:

- Bill and Mercedes have \$160,000 of taxable income (salaries) and additional \$10,000 of nontaxable income (Gift from Bill's father).
 - Using the 2017 married-joint tax rates, what is their tax due, **average** tax rate, and **effective** tax rate?



Measure Tax Rates

Example 7:

- The income tax for the taxable year 2017:

● \$ 160,000	
● - <u>153,101</u>	\$29,752.50
● \$ 6,899 * 28% =	<u>1,931.72</u>
● TAX	<u>\$31,684.22</u>



Measure Tax Rates

Example 7:

- **Average tax rate:**
 - 19.80% ($\$31,684.22 / 160,000$)

- **Effective tax rate:**
 - 18.63% ($\$31,684.22 / 170,000$)



Measure Tax Rate

1.5 Regressive Tax Rate:

- Imposes:
 - a decreasing marginal tax rate as the tax base increases.
 - a increasing marginal tax rate as the tax base decrease.

- **Example:** Sales Tax.



Measure Tax Rates

Example 8:

- **Bill and Mercedes:**
 - Total purchases subject to 7% sales tax = \$70,000
 - Sales tax = \$4,900 ($\$70,000 * 7\%$)
 - Total income = \$300,000
 - Effective tax is 1.6% = $\$4,900/\$300,000$
- **Marc**
 - Total purchases subject to 7% sales tax = \$30,000.
 - Sales tax = \$2,100 ($\$30,000 * 7\%$)
 - Total income = \$75,000
 - Effective tax is 2.8% = $\$2,100/\$75,000$
- The sales tax is a regressive tax.

Types of Taxes





Types of Taxes

2.1 Federal Taxes:

- Income taxes
- Employment and unemployment taxes
- Excise taxes
- Transfer taxes (*Estate and Gift Taxes*)



Types of Taxes

2.2 Federal Taxes (Descriptions):

1. Income taxes

- Represents approximately 55.3% of all tax revenues collected in the United States (Individuals 47.4% and Corporations 7.9%).
- Levied on individuals, corporations, estates, and trusts.



Types of Taxes

2.2 Federal Taxes (Descriptions):

2. **Employment and Unemployment taxes**

- Second largest group of taxes imposed by the U.S. government.
- Employment taxes include the OASDI (Social Security tax), and the MHI tax (Medicare tax).
- Unemployment taxes fund temporary unemployment benefits for individuals terminated from their jobs without cause.



Types of Taxes

2.2 Federal Taxes (Descriptions):

3. Excise taxes

- Third largest group of taxes imposed by the U.S. government.
- Levied on the *quantity* of products sold.



Types of Taxes

2.2 Federal Taxes (Descriptions):

4. Estate and Gift taxes

- Levied on the fair market values of wealth transfers upon death or by gift.



Types of Taxes

2.3 State and Local Taxes:

- Sales and use taxes
- Property taxes
- Income taxes
- Excise taxes
- Employment and unemployment taxes (PR)
- Transfer taxes (*Estate and Gift Taxes*) (PR)
 - Repealed in P.R. effective in January 1, 2018.
- Municipal Taxes and others (PR)



Types of Taxes

2.4 State and Local Taxes (Descriptions):

1. Sales and Use taxes

- Tax base for a sales tax is the retail sales of goods and some services.
- Tax base for the use tax is the retail price of goods owned, possessed or consumed within a state that were *not* purchased within the state.



Types of Taxes

2.4 State and Local Taxes (Descriptions):

2. Property taxes

- Property taxes are ad valorem taxes, meaning that the tax base for each is the fair market value of the property.
- Real property taxes consists of taxes on land and structures permanently attached to land.
- Personal property taxes includes taxes on all other types of property, both tangible and intangible.



Types of Taxes

2.4 State and Local Taxes (Descriptions):

3. Income taxes

- Most state taxable income calculations largely conform to the federal taxable income calculations, with a limited number of modifications.



Types of Taxes

2.4 State and Local Taxes (Descriptions):

4. Excise taxes

- States typically impose excise taxes on items subject to federal excise tax.

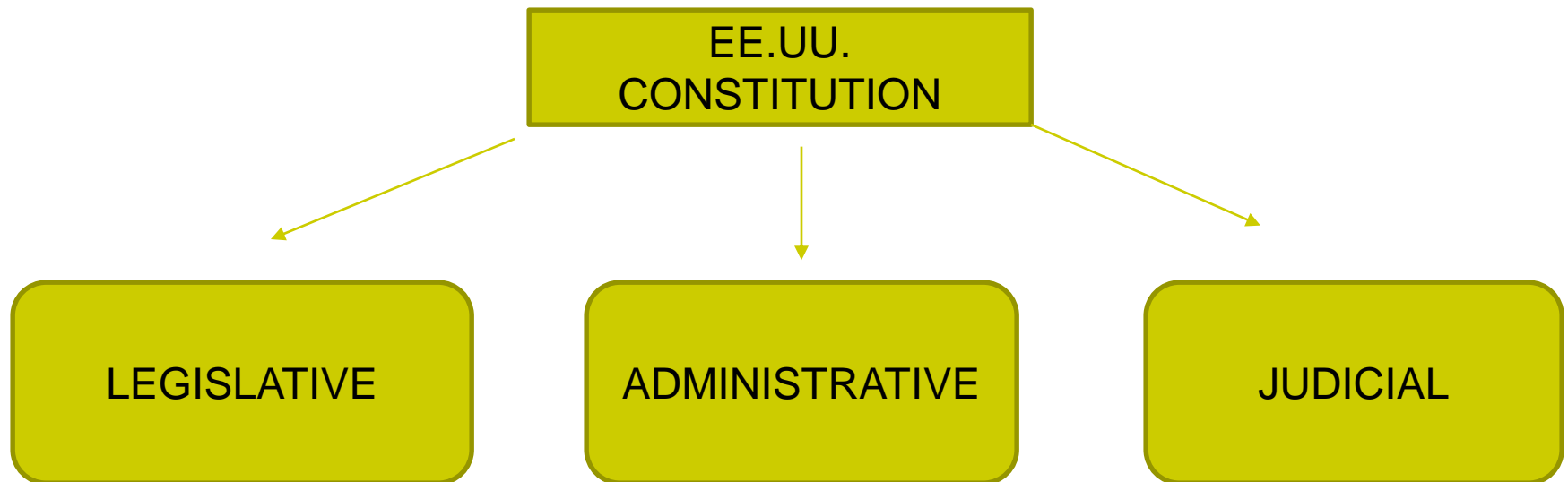
Legal Structure of the Tax System





Legal Structure of the Tax System

3.1 Government Structure





Legal Structure of the Tax System

Area	Responsible	Tax Law Source
Legislative	Congress	Tax laws (Internal Revenue Code)
Administrative	U.S. Treasury	Regulations Revenue Rulings Revenue Procedures
Judicial	Judicial System	U.S. Supreme Court U.S. Circuit Court of Appeals U.S. Tax Court U.S. Court of Federal Claims U.S. District Court

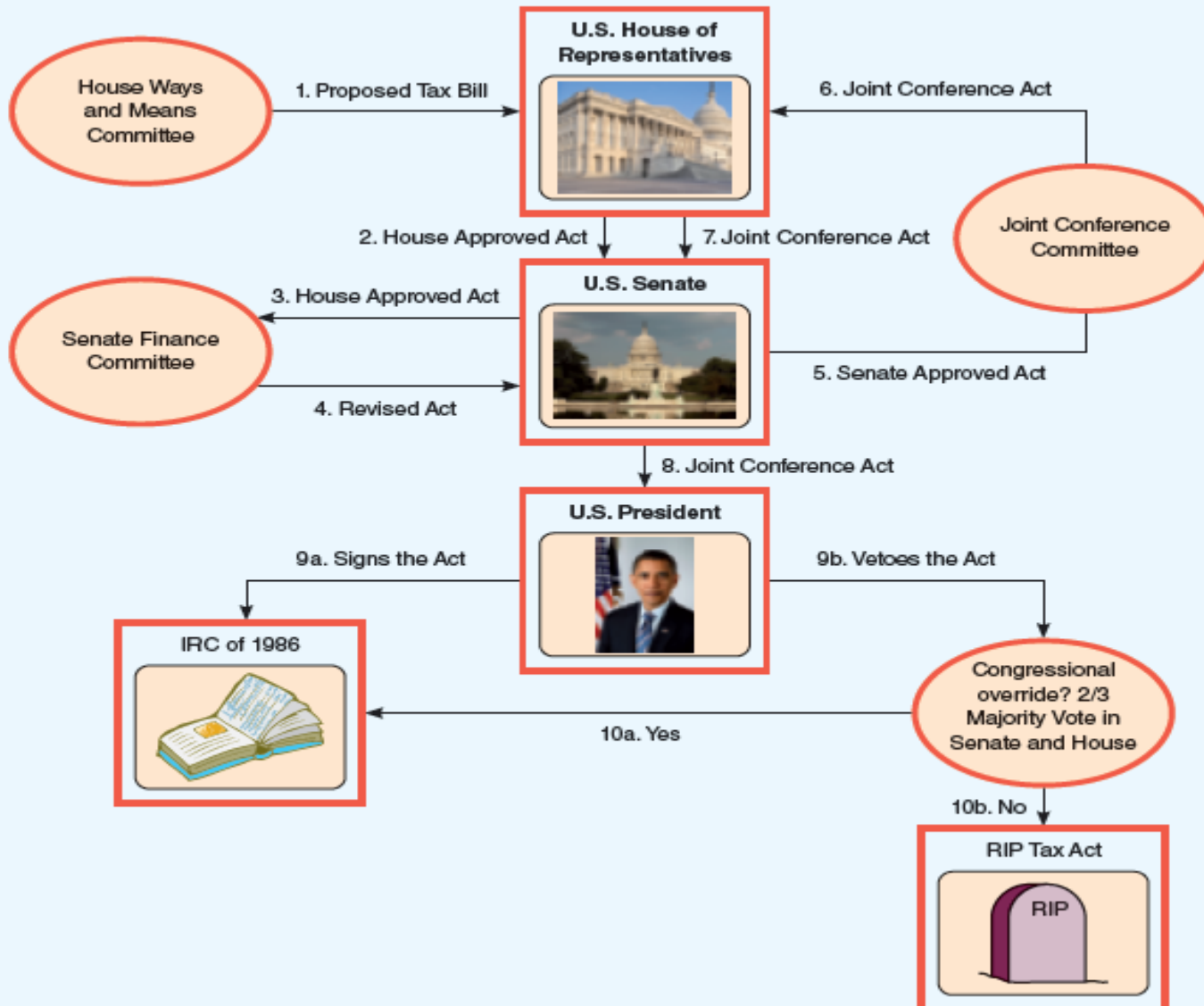
Legislative Process



4.1 Legislative Process



EXHIBIT 2-7 Tax Legislation Process



Legislative Process



4.2 Tax Legislation (Statutory Authority):

1. Internal Revenue Code

- The main statutory authority
- Changes enacted by Congress

Legislative Process*



4.2 Tax Legislation (Statutory Authority):

1. Internal Revenue Code

- Organization of Internal Revenue Code:

Subtitle A – Income Taxes

Chapter 1 – Income Taxes

Subchapter A – Determination of Tax Liability

Part I – Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc. (Sec. 61 – 68)

Sec. 61 – Gross Income Defined

Sec. 62 – Adjusted Gross Income Defined

Sec. 63 – Taxable Income Defined

Subsection 63(c) – Standard Deduction

Paragraph 63(c)(2) – Basic Standard Deduction

Subparagraph 63(c)(2)(A) - ...

Clause 63(c)(2)(A)(i) - ...

Legislative Process



4.2 Tax Legislation (Statutory Authority):

2. US Congress Committee Reports:
 - Senate Finance Committee Report
 - House Ways and Means Committee Report
 - Joint Conference Committee

Administrative Process



Administrative Process



5.1 Treasury Department Interpretations

1. Regulations
2. Revenue rulings
3. Revenue Procedures
4. Letter Rulings

Administrative Process



5.2 Regulations

- Treasury departments official interpretation of the Internal Revenue Code
 - **3 Different Forms:**
 - *Final*: Treasury's interpretation of the Code.
 - *Temporary*: Limited life (three years).
 - *Proposed*: Issue to allow public comment on them.

Administrative Process



5.3 Revenue Rulings

- Less authoritative weight, but they provide a much more detailed interpretation of the Code.
- Application to a specific factual situation.

Administrative Process



5.4 Revenue Procedures

- Explain in great detail IRS practice and procedures in administering tax law.

Administrative Process



5.5 Letter Rulings

- Less authoritative but more specific than revenue rulings and regulations.
- Applied to a specific taxpayer.
- May not be used as precedent by taxpayers.

Administrative Process



5.5 Letter Rulings

1. **Private Letter Rulings:** Issued in response to a taxpayer request and are common for proposed transactions with potentially large tax implications.
2. **Determination Letter:** Issued by local IRS directors for noncontroversial issues.
3. **Technical Advice Memorandums:** Requested by an IRS agent during an IRS audit.
4. **Acquiescence or Nonacquiescence Notice:**
 - *Acquiescence:* IRS will no longer litigate this issue.
 - *Nonacquiescence:* IRS will continue to litigate this issue.

Administrative Process



5.6 Hierarchy of Administrative Sources

- First Administrative Authoritative Weight
 - Regulation **More Weight**
 - Second Administrative Authoritative Weight
 - Revenue Ruling
 - Revenue Procedures
 - Third Administrative Authoritative Weight
 - Letter Rulings **Less Weight**
- A vertical yellow arrow points downwards from the right side of the 'Second Administrative Authoritative Weight' section to the 'Third Administrative Authoritative Weight' section.

Judicial Process



Judicial Process



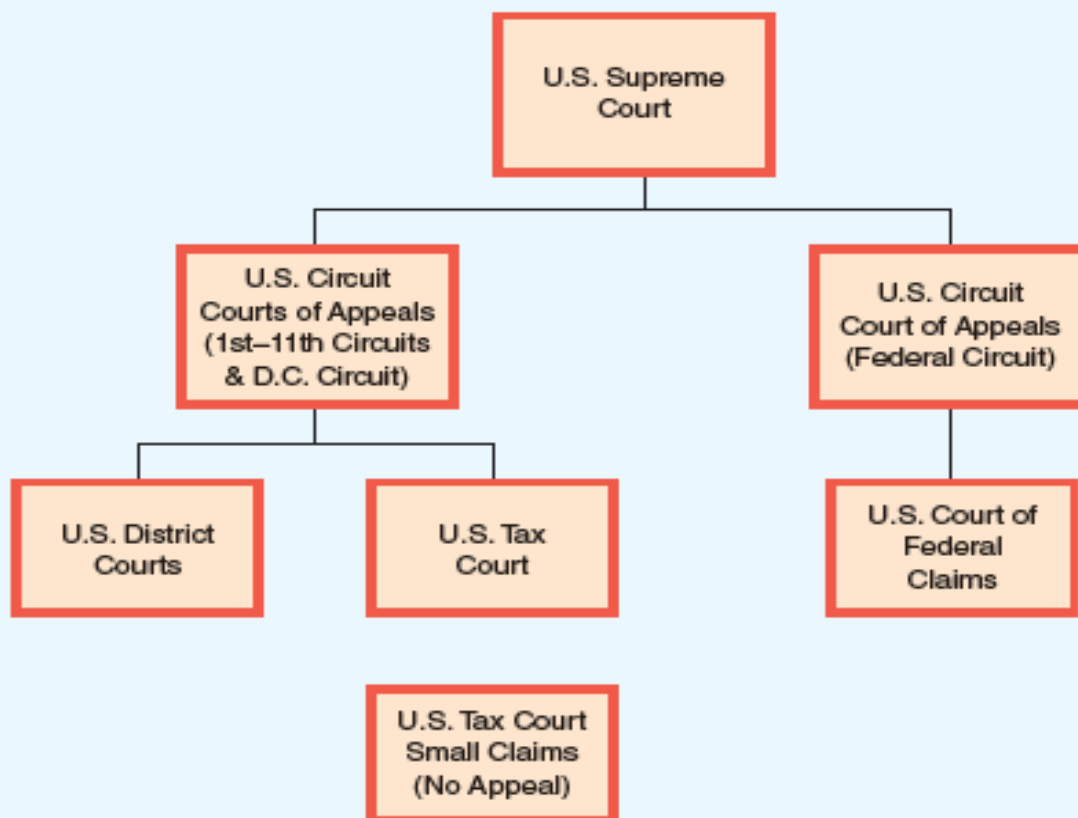
6.1 Judicial System

- Tasked with the ultimate authority to interpret the Internal Revenue Code and settle disputes between taxpayers and the IRS.



Judicial Process

EXHIBIT 2-3 Federal Judicial System





Judicial Process

6.2 Trial Level Courts

- Three (3) trial level courts that interpret and rule differently on the same basic tax issue:
 - U.S. District Court
 - Tax Court
 - U.S. Court of Federal Claims



Judicial Process

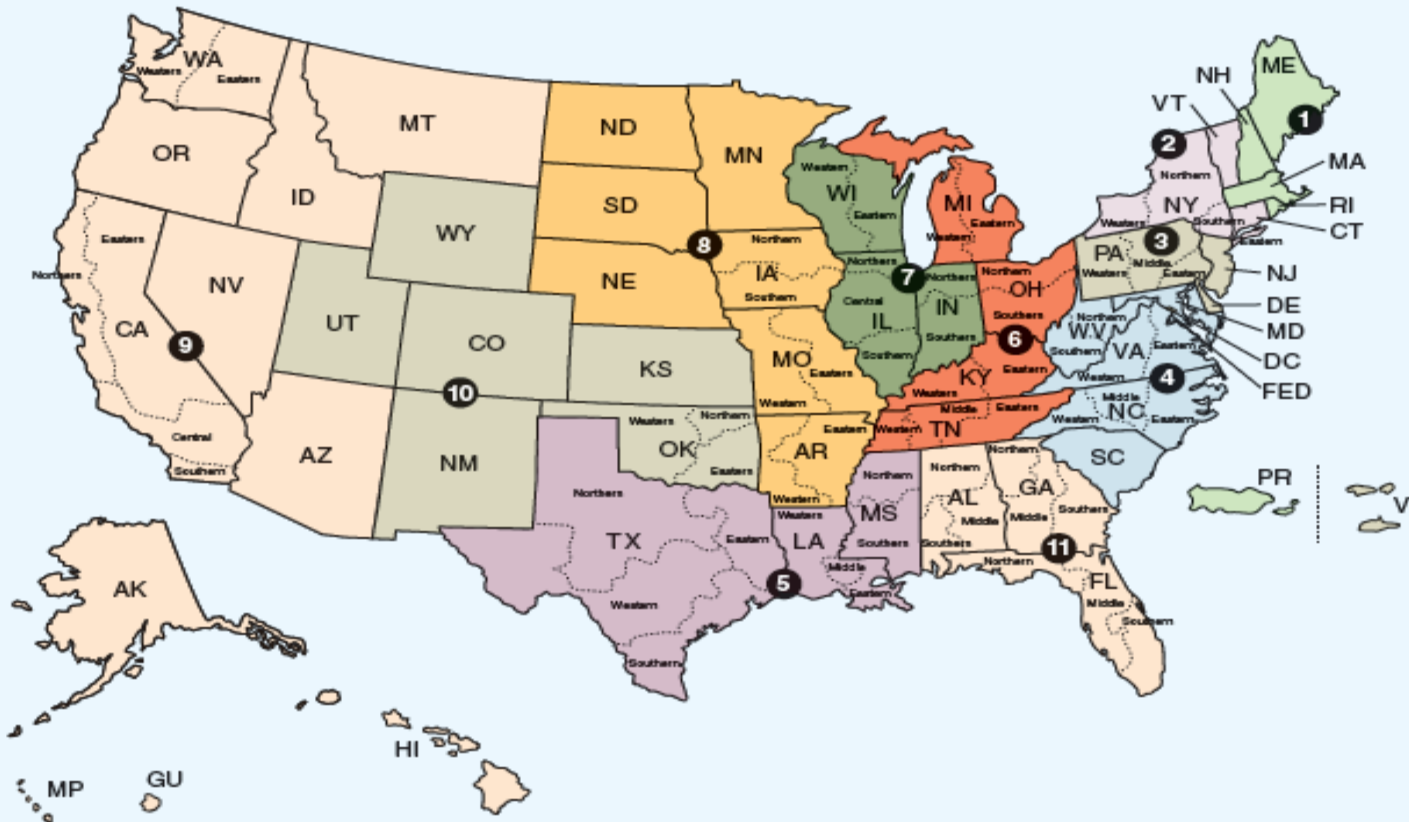
6.3 Court of Appeals

- 13 Circuit Courts which is the next level of judicial authority.



U.S. Circuit Courts of Appeal

EXHIBIT 2-4 Geographic Boundaries for the U.S. Circuit Courts of Appeal



Source: www.uscourts.gov/courtlinks

*U.S. District Court jurisdictions for those states with more than one U.S. District Court are also depicted (for example, the state of Washington is divided into Eastern and Western Districts).

†Not depicted are the U.S. Circuit Court of Appeals for the District of Columbia and the U.S. Circuit Court of Appeals for the Federal Circuit.

Judicial Process



6.4 Supreme Court

- The highest judicial authority and is on the same level with the Internal Revenue Code with regard to authority.
 - The Supreme Court hear only a few tax cases a year with great significance to a broad cross-section of taxpayers, or cases litigating issues in which there has been disagreement among the circuit courts.
 - For most tax cases, the Supreme Court refuses to hear the case (denies the writ of certiorari) and litigation ends with the circuit court decision.

Judicial Process



6.5 Judicial Doctrine

- All courts apply the judicial doctrine of ***stare decisis***, which means that a court will rule consistently with its previous rulings and the rulings of higher courts with appellate jurisdiction. The Tax Court applies the **Golsen** rule.

Tax Law Sources Summary



Tax Law Sources



7.1 Primary Authorities

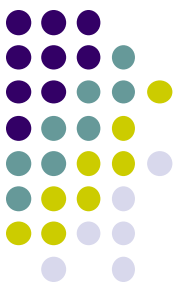
- Official sources of tax law:
 1. **Statutory sources**
 - U.S. Constitution (16th Amendment provides Congress the ability to tax income directly.)
 - Tax Treaties (agreements negotiated between countries)
 - Internal Revenue Code
 2. **Judicial sources**
 - Court decisions (Supreme Court, Court of Appeals)
 3. **Administrative sources**
 - Treasury and IRS pronouncements (Regulations, Revenue Rulings, Revenue Procedures)

Tax Law Sources



7.2 Secondary Authorities

- Unofficial tax authorities
 1. Tax services
 2. Tax articles
 3. Tax textbooks
 4. Quick reference sources



Secondary Tax Authorities

EXHIBIT 2-6 Common Secondary Tax Authorities

Tax Research Services:

BNA Tax Management Portfolios
CCH Standard Federal Tax Reporter
CCH Tax Research Consultant
RIA Federal Tax Coordinator
RIA United States Tax Reporter

Newsletters:

Daily Tax Report
Federal Tax Weekly Alert
Tax Notes

Law Reviews:

Tax Law Review (New York University School of Law)
Virginia Tax Review (University of Virginia School of Law)

Professional Journals:

Journal of Accountancy
Journal of Taxation
Practical Tax Strategies
Taxes
Tax Adviser

Quick Reference Sources:

IRS Publications
CCH Master Tax Guide
RIA Federal Tax Handbook

Textbooks:

McGraw-Hill's Taxation of Individuals and Business Entities
McGraw-Hill's Essentials of Federal Taxation

Tax Research



Tax Research



Steps	Description	Example
1	Understand the facts.	Taxpayer, as employee, received a “gift” of \$10,000 from employer.
2	Identify issues.	Is the gift of \$10,000 taxable as compensation or exempt as a gift?

Tax Research



Steps	Description	Example
3	Locate relevant authorities. (Evaluate the “ hierarchy ,” jurisdiction , and age)	<ol style="list-style-type: none">1. <u>§61 I.R.C</u>: Definition of income.2. <u>Reg. §1.61</u>3. <u>§102(a) I.R.C</u>: Exclusion of gift as income.4. <u>Comm. v. Duberstein</u>, 363 U.S. 278 (1960): the transfer of a Cadillac from employer to employee is to recompense for past services.

Tax Research



Steps	Description	Example
4	Analyze tax authorities.	The Supreme Court is the highest judicial authority to interpret the law.

Tax Research



Steps	Description	Example
5	Document and communicate the results.	Letter or memo: Taxpayer must report as taxable compensation the \$10,000 received by employer. (Support conclusion with the relevant authorities.)