CHAPTER 2
INCOME TAX CONCEPTS

I. Income Tax as an Artificial System

A. Artificial v. Natural Systems

1. All systems are based on Concepts and Rules - Artificial systems also have exceptions to the general Concepts and Rules which are usually not present in naturally occurring systems.

II. CONCEPTS

A. Broad, general theories or philosophies that provide the basic framework for the intended results of the system. Due to their very nature (broad, general), CONCEPTS provide overall guidance but generally require more detailed rules and procedures to implement the CONCEPT.

1. Constructs - A mechanism developed to implement a CONCEPT. Constructs are usually statutory or Administrative in origin.

2. Doctrines - Judicially developed Constructs. That is, the only difference a Construct and a Doctrine is it's origin. Both are simply devices developed to implement CONCEPTS.

3. When we refer to a CONCEPT, we implicitly include all of the CONCEPT'S related Constructs and Doctrines.

B. The basic CONCEPTS and their related Constructs and Doctrines are introduced prior to the actual study of the individual components of the tax calculation. There are two advantages to this method:

1. If you learn the basics of the system first (long-term memory), then as you study new material, the introduction of the related CONCEPT will give you a mental linkage to help you learn the new material (get it into long-term memory).

2. If you can learn the basics of the system, then you should be able to determine the tax treatment of any item by reference to the treatment prescribed by the CONCEPTS. This allows you to focus more attention on the study of the exceptions to general rules of the system.

III. General Concepts

A. Provide overall guidance on the operation of and implementation of the income tax system. As such, they underlie many of the items in the system.

B. ABILITY TO PAY CONCEPT

1. The tax should be levied at an amount that the taxpayer can afford to pay.

2. Two main results of the Concept

a. Tax Base is Taxable Income - Income net of deductions

1. Income, Exclusion, deduction, exemption, tax credit are all Constructs that implement the ABILITY TO PAY Concept.

b. Progressive Tax Rates - 10%, 15%, 25%, 28%, 33%, 35%

1. However, as can be seen from examining the tax rate schedules, this Concept is also implemented by the use of varying Average Tax Rates by Filing Status of the taxpayer.

C. ADMINISTRATIVE CONVENIENCE CONCEPT

1. This Concept allows for omission of an item from the tax base when the cost of complying with the treatment of the item, as prescribed by the Concepts, exceeds the revenue that would be received from including the item in the tax base.

a. Many items which would meet the definition of income are omitted because the costs of compliance are too high.

b. Use of Standard Deduction amounts for individual taxpayers.

D. ARMS-LENGTH TRANSACTION CONCEPT

1. **A transaction in which all parties to the transaction have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. i.e. a fair market value is the bargained price.**

   a. **Transactions that are not made at ARMS-LENGTH are usually not given their intended tax effect.**

2. **Related Party Provisions (Rules)**

   a. **You are deemed to not transact at Arms-length with a Related Party. Related Parties are:**

      1) **Family members - brothers, sisters, spouse, parents, ancestor's and lineal descendants.**

      2) **A corporation (partnership) in which you own > 50% of the stock.**

      3) **A corporation and a partnership in which the same person(s) own more than 50% of each.**

E. PAY-AS-YOU-GO CONCEPT

1. **Payment of the tax should be made as close as possible to the time at which the income is earned.**

   a. **Withholding**

   b. **Estimated Tax Payments**

IV. ACCOUNTING CONCEPTS

A. Accounting Concepts are necessary for the proper recording and reporting of items that affect taxable income. That is, they guide us in how to determine the appropriate taxpayer entity and the correct period for inclusion of the item.

B. ENTITY CONCEPT

1. **All transactions must be traced to, recorded and reported by a single income tax entity.**

   a. **Taxable Entities - Entities that actually pay tax on the income they generate.**

      1) **Individual, Corporations, Estates & Trusts**

   b. **Conduit Entities - Entities that are tax reporting entities. In a Conduit Entity, the income earned is reported to the government, but no tax is paid by the entity itself. The tax attributes (income, deductions, credits, etc.) of the conduit flow through to the owners of the entity. The owners add the results to their other income and pay tax on the total of all of their income.**

      1) **Sole Proprietorships, Partnerships, S Corporations**

2. **Assignment of Income Doctrine - the owner of the income is taxed on the income. Taxation cannot be escaped by assignment of the payment to another entity.**

C. ANNUAL ACCOUNTING PERIOD CONCEPT

1. **All entities must report the results of their operations on an annual basis (the tax year). Each tax year is to stand separate and apart from other tax years (i.e. we rarely go back and amend a prior year when new information suggests that something in that year was not correct).**

   a. **Accounting Period**

      1) **Calendar**

      2) **Fiscal**

   b. **Accounting Method**

      1) **Cash**

      2) **Accrual**

c. **Tax Benefit Rule - any deduction taken in a prior year that is recovered in a subsequent year is income in the year of recovery to the extent that a tax benefit was received from the recovered deduction. The tax benefit received is the reduction in taxable income that occurred because of the deduction.**

d. **Substance Over Form Doctrine - the taxability of a transaction is determined by its reality, rather than some possibly contrived appearance. Transactions are taken at their face value only when there is some genuine economic purpose to the transaction other than the avoidance of tax.**

V. INCOME CONCEPTS

A. **Provide guidance on what should be taxed, how an item should be taxed, and when it should be taxed.**

B. ALL-INCLUSIVE INCOME CONCEPT

1. **All income received is taxed unless some specific provision in the tax law excludes the item from taxation.**

C. LEGISLATIVE GRACE CONCEPT

1. **Any relief from tax must be specifically provided by Congress. The tax relief provisions must be strictly applied and interpreted.**

NOTE: The combined effect of the all-inclusive income and legislative grace concepts is the definition of gross income: all income - exclusions.

2. **Capital Gains/Losses - a gain or loss that results from the sale of a Capital Asset.**

a. **Definition - Any asset that is not a receivable, inventory, real or depreciable property used in a trade or business and certain intangible assets.**

1) **The most common types of capital assets are stocks, bonds, personal use property, and other investment related assets such as rental properties.**

b. **Treatment - Net Long-Term (held > 1 year) Capital Gains of individuals are taxed at a 15% rate (5% for 10% or 15% marginal tax rate taxpayers. 0% in 2009-2010.) Gains on Collectibles not eligible for 15% rate (taxed at a maximum of 28%).**

   Net Capital Loss deductions of individuals are limited to $3,000 per year for individuals.

   Corporations get no tax relief for net capital gains and cannot deduct net Capital Losses (must carryback 3 years and forward 5 years).

c. **Dividends – Dividends received from qualified corporations are taxed at the long-term capital gains rate. (2003 Act)**

D. CAPITAL RECOVERY CONCEPT

1. **No income is taxed until all the capital investment in the asset has been recovered.**

   a. **Basis - The amount of capital invested in an asset.**

E. REALIZATION CONCEPT

1. **No income is recognized (included in gross income) until it has been realized. An ARMS-LENGTH TRANSACTION is generally necessary for a realization to occur.**

   a. **Mere changes in value are not recognized until they are realized through an ARMS-LENGTH TRANSACTION.**

2. **Claim of Right Doctrine - income is taxable when it is received without any restrictions as to its use; i.e. there is no clear and definitive obligation to repay. The fact that you may have to repay all or part of the income at some future date does not restrict its current use.**

   a. **The Claim of Right doctrine is relevant whenever an amount of (possible) income has been received.**

   b. **The doctrine is applicable to both cash and accrual basis taxpayers.**

1) **Loans, security deposits, and any other amount received under a clear obligation to repay is not income when received.**

3. **Constructive Receipt Doctrine - A cash basis taxpayer is in receipt of income when the income is made unconditionally available to them. The income does not have to be physically received nor does it have to be in the form of cash to be constructively received.**

   a. **The Constructive Receipt doctrine is concerned with situations where cash basis taxpayers have effectively received income that is not in their physical possession.**

F. WHEREWITHAL-TO-PAY CONCEPT

1. **Income should be recognized and a tax paid in the period in which the taxpayer has the resources available to pay the tax.**

2. **Implications**

   a. **Most receipts of prepaid income by accrual basis taxpayers are taxed in the period of receipt, not the period earned.**

   b. **The tax law provides that several types of gains may be deferred because the transactions do not produce any assets to pay the tax on the gain realized.**

VI. DEDUCTION CONCEPTS

A. **Provides guidance on what is deductible, how much is deductible, and when the deduction should be taken.**

B. LEGISLATIVE GRACE CONCEPT

1. **Because deductions are a form of tax relief, only Congress has the power to allow deductions. The deductions allowed must be strictly applied and interpreted.**

2. **In contrast to income, the approach to deductions is to assume that nothing is deductible unless a specific provision in the tax law can be**

found that allows the deduction.

C. BUSINESS PURPOSE CONCEPT

1. **Deductions are allowed for expenditures that have a business or economic purpose, which exceeds any tax avoidance motive. i.e. the motive for the expenditure determines the tax treatment.**

   a. **In general, this means that the transaction creating the expenditure must be profit motivated. That is, by making the expenditure the taxpayer is seeking to make a profit (Note that transactions can be entered into for a profit and for the added profit from the tax benefits the transaction creates).**

2. **This concept is incorporated into the tax law through the allowance of the ordinary and necessary expenses of:**

   a. **A Trade or Business (Business Expenses)**

   b. **A Production of Income Activity (Investment Expenses)**

3. **Personal expenditures are specifically disallowed. However, certain specified personal expenditures called ITEMIZED DEDUCTIONS are allowed to be deducted.**

4. **In analyzing the deductibility of any expenditure, the first step is to determine whether it is:**

   a. **Related to a profit motivated activity, or**

   b. **Is a Personal Expenditure**

5. **For expenditures related to profit motivated activities, it must be determined whether the activity is a:**

   a. **Trade or Business, or**

   b. **Investment Activity**

6. **Once the classification of the expenditure is determined, rules for each class of expenditure are used to determine the amount of the deduction.**

   a. **All ordinary, necessary, and reasonable expenses related to a Trade or Business are deductible. The only limit placed on the amount of the deduction for a trade or business related expense is that the expense be reasonable in amount.**

   b. **All ordinary, necessary, and reasonable expenses related to an Investment Activity are allowed as deductions. However, the amount of the deduction may be limited due to the nature of the activity (Passive Losses) or the amount may be limited by a percentage of the taxpayer's income (investment expenses of individuals have a 2% of adjusted gross income limitation).**

   c. **Only specifically allowed personal expenditures are deductible. The general classes allowed are Medical, Interest, Taxes, Charitable Contributions, Personal Casualty Losses, and various Miscellaneous Itemized Deductions. These expenditures have various limits on the amount that may be deducted. The limit is tied to the taxpayers income.**

      1. **Taxpayers who incur minimum amounts of these allowable personal expenditures are entitled to deduct a Standard Deduction in lieu of actual expenditures.**

D. CAPITAL RECOVERY CONCEPT

1. **No income is realized until the amount invested to produce the income is recovered. This means that the deductible amount of an expenditure can never exceed its cost (the amounted invested).**

2. **Capital Expenditures - Any expenditure, the benefit of which extends beyond the current period, must be capitalized and recovered through time.**

    a. **Capital expenditures include investments in fixed assets (land, building, machinery, etc.), prepaid expenses, and investments in stocks, bonds, etc.**

    b. **Capital expenditures are recovered either:**

        1. **Through Time (depreciation, amortization)**

        2. **At point of disposition**

    c. **As expenditures are recovered through time (i.e., current deductions against income), the amount that can be recovered at disposition must be reduced. i.e. the total recovery on a capital expenditure can never exceed the amount invested.**

        1. **Adjusted Basis - The amount of unrecovered investment in an asset at any point in time.**

            a) **Adjusted Basis = Original Basis + Additions - Reductions**