

# Tax Planning

## Chapter Outline

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Economics of Tax Planning, Avoidance, and Evasion

Tax Rate Terminology

Tax Base

Tax Rates

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Fundamentals of Tax Planning

Avoiding Income Recognition

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Exploiting Inconsistencies in the Statute

Inconsistencies between Transactions

Inconsistencies between Taxpayers

Inconsistencies between Years

Avoiding Tax Traps

Statutory Tax Traps

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## Learning Objectives

- Identify several fundamental tenets of tax planning for optimizing tax liabilities.
- Gain perspective as to the role of tax planning in tax practice.
- Define and apply several key terms with respect to tax rate schedules.
- Illustrate effective tax planning as found in today's tax profession.

**I**N THIS CHAPTER, WE return to that element of the tax practice consisting of tax planning, as it was introduced in Chapter 1. A working knowledge of tax planning concepts is imperative for the researcher, because tax avoidance constitutes both (1) an important part of tax practice and (2) a prime motivation in the “open-fact” research context.

For most practitioners, tax research and planning represent the “glamor” end of the business. Properly accomplished tax planning:

- Forces the client to identify financial goals and general means by which to achieve them.
- Allows the tax professional to exercise a higher degree of creativity than in any other part of the practice.
- Affords the practitioner the greatest possible degree of control over the prescribed transactions and the tax consequences.

The tax planning process finds the tax professional in the roles of technical expert, friend, seer, and confessor priest for the client. It offers an opportunity for the most psychologically and financially rewarding work possible, in the context of a tax practice.

## **ECONOMICS OF TAX PLANNING, AVOIDANCE, AND EVASION**

From both the Treasury and the taxpayer viewpoint, taxes can modify individual decisions. Taxes represent an additional cost of doing business or of accumulating wealth. Assuming that economists are correct in speaking about the ways in which a rational citizen makes day-to-day decisions, taxpayers employ tax planning techniques to accomplish the overall goal of wealth maximization.<sup>1</sup> Because taxes deplete the wealth of the taxpayer, planning behavior is designed to reduce the net present value of the tax liability. This is not the same as a simple reduction of taxes in current, nominal dollar terms, an objective that is so often assumed by laypeople, the media, and others, including too many tax advisors.

**Example 12-1** Sharon can choose between two business plans. One will cost her enterprise \$1,000 in taxes today. The other will cost the business \$2,000 in taxes ten years from now. The plans are identical in all other ways. Prevailing interest rates average 10 percent. Because the present value of the taxes levied with respect to the second alternative are about \$800, Sharon should choose the latter plan, that is, the one with the higher nominal dollar tax cost.

If prevailing interest rates average 5 percent during the ten-year planning period, the present value of the taxes levied under the second alternative would be about \$1,225, so the first plan, the one that requires an immediate tax payment, should be adopted.

In one important sense, the Federal income tax is its own worst enemy. Taxpayers are rewarded more for finding ways to save taxes than for earning an equal amount in the marketplace. This incentive for tax planning is the result of two rules of tax law.

<sup>1</sup>We use “wealth” in its broadest sense here; that is, an individual may choose increased leisure time or other forms of so-called psychic income over traditional forms of wealth. Wealth, the accumulation of which constitutes the overall goal for the specified time period, thus can include measures of happiness, satisfaction, investment, and control over time and other resources.

The first such rule is that the Federal income tax itself is not allowed as a deduction in determining taxable income. Consequently, reducing the amount of income taxes that are paid does not decrease one's allowable deductions and, hence, does not trigger any further increase in taxable income. Instead, the full amount of any tax that is saved increases after-tax income; that is, the tax savings themselves do not constitute taxable income. Unlike most profit-seeking activities, tax planning produces benefits that are completely exempt from income taxation.

The second such rule allows a deduction for any business-related expenses that are incurred in connection with the determination of a tax. Most tax planning costs are deductible by business owners and sole proprietors, but only a few employee-individuals qualify for such a deduction. The net cost of a tax planning project, then, is its gross cost minus the amount of the reduction in the tax liability that is generated by the attendant deduction. In concise terms, the after-tax cost of tax planning can be expressed as follows.

$$\text{ATC} = \text{BTC} \times (1 - \text{MTR}) \text{ where}$$

**ATC** = after-tax cost

**BTC** = before-tax cost

**MTR** = marginal tax rate

In relating both rules to tax planning projects, one can see that such endeavors enjoy an economic advantage over most other profit-seeking activities. In evaluating most other investment projects, the decision maker must compare after-tax benefits with after-tax costs. Yet, for tax planning projects, the payoffs are tax free, while the costs usually remain tax-deductible. Thus, for tax planning activities, one effectively compares pretax benefits with after-tax costs.

**Example 12-2** Shull Corporation, subject to a marginal state and Federal income tax rate of 40 percent, is considering two mutually exclusive alternatives. Alternative A is to hire a university accounting major for the summer at a cost of \$2,000; his task would be to undertake research on a tax avoidance plan. If it is successful, the plan would save the corporation \$1,600 in Federal income taxes. The probability of success for the plan is estimated at 80 percent. Alternative M is to hire a university marketing major for the summer at a cost of \$1,800; her task would be to undertake research on a marketing plan. If it is successful, this plan would generate new revenues of \$2,000. The probability of such success is estimated to be 85 percent. Which, if either, alternative should Shull pursue?

	Alternative A	Alternative M
Before-tax cost	\$2,000	\$1,800
Tax reduction (40%)	-800	-720
After-tax cost	<u>\$1,200</u>	<u>\$1,080</u>
Possible pretax payoff	\$1,600	\$2,000
Probability of success	<u>×.80</u>	<u>×.85</u>
Expected pretax payoff	\$1,280	\$1,700
Tax on expected payoff (40%)	<u>-0</u>	<u>-680</u>
Expected after-tax payoff	<u>\$1,280</u>	<u>\$1,020</u>
Excess of after-tax payoff over after-tax cost	<u>\$ 80</u>	<u>\$ (60)</u>

**Decision:** Even though Alternative M offers a higher pretax payoff, a lower before-tax cost, and a higher probability of success, Alternative A should be accepted.

The facts of this example illustrate the apparent built-in economic bias of current tax law for tax planning projects, relative to other, seemingly more productive activities.

The analysis of Example 12-2, like most of the illustrations in this book, is based on a “marginal” viewpoint. Its purpose is to determine the effect of the transactions at issue, assuming that all other characteristics of the situation do not change. When it is viewed from this perspective, the after-tax cost of any deductible expenditure decreases if the marginal tax rate is increased. This fact may explain why lower-income taxpayers, who are subject to lower marginal tax rates, engage in tax planning activities less often than do higher-income taxpayers.

**Example 12-3** Assume the same situation and opportunities as in Example 12-2, except that Shull’s marginal tax rate is 20 percent.

	Alternative A	Alternative M
Before-tax cost	\$2,000	\$1,800
Tax reduction (20%)	-400	-360
After-tax cost	<u>\$1,600</u>	<u>\$1,440</u>
Possible pretax payoff	\$1,600	\$2,000
Probability of success	<u>× .80</u>	<u>× .85</u>
Expected pretax payoff	\$1,280	\$1,700
Tax on expected payoff (20%)	<u>-0</u>	<u>-340</u>
Expected after-tax payoff	<u>\$1,280</u>	<u>\$1,360</u>
Excess of after-tax payoff over after-tax cost	<u><u>\$ (320)</u></u>	<u><u>\$ (80)</u></u>

**Decision:** Accept Alternative M, because it generates the lesser after-tax loss, or undertake neither (seemingly profitable) project. The change in the marginal tax rate alone resulted in a different decision by Shull.



## SPOTLIGHT ON TAXATION

### Observation

Sometimes it is difficult to get a taxpayer to think in “after-tax” terms, so “bad” decisions can be made. For other taxpayers, there is an impression that the government fully reimburses a deduction, that is, a \$1 “write-off” means that there is no cost to the taxpayer. The tax planner often must act as educator to eliminate both of these mistaken impressions.

## TAX RATE TERMINOLOGY

The basic formula for computing a taxpayer’s liability is

$$\text{Tax Liability} = \text{Tax Base} \times \text{Rate}$$

Thus, in many respects, the function of a legislative body is to define adequately the appropriate tax base and construct a schedule of tax rates, so that the ensuing

liabilities will be in accordance with the prevailing revenue and nonrevenue objectives of the tax system. Once a tax has been included in a society's tax structure, legislative efforts seem to focus on slight modifications of the existing tax base and rates; major overhauls, additions, or deletions to the structure rarely are considered. Tax reform legislation thus usually takes the form of "fine-tuning" the system rather than "changing channels" altogether.

## Tax Base

The income tax is the most modern of the taxes that are commonly found in contemporary industrialized societies. Allowing for the difficulties in constructing a definition for a virtually imaginary concept, most policymakers believe that a tax that is based on "ordinary taxable income," allowing deductions for the costs of earning such income and for certain personal expenditures, best reflects the capacity of the taxpayer to support government finance.

Previous efforts to base taxation on ability to pay have included taxes on individual consumption and wealth. Consumption taxes are supported by the rationale that the taxpayer receives personal benefit from society in accordance with the amount of goods and services that he or she exhausts during the period; thus, the government should appropriate its share of finances from what people take out of society's "kitty" for personal reasons, not from what they put into it, as is the case under income taxation.

Wealth or property taxes also have been structured to base levies on one's capacity to support the government. Most often, wealth taxes take the form of levies against the net holdings of tangible assets that are controlled by the taxpayer at a given time. In accounting terminology, the tax on the net tangible assets is assessed on what appears on the taxpayer's balance sheet at the end of the taxable year.

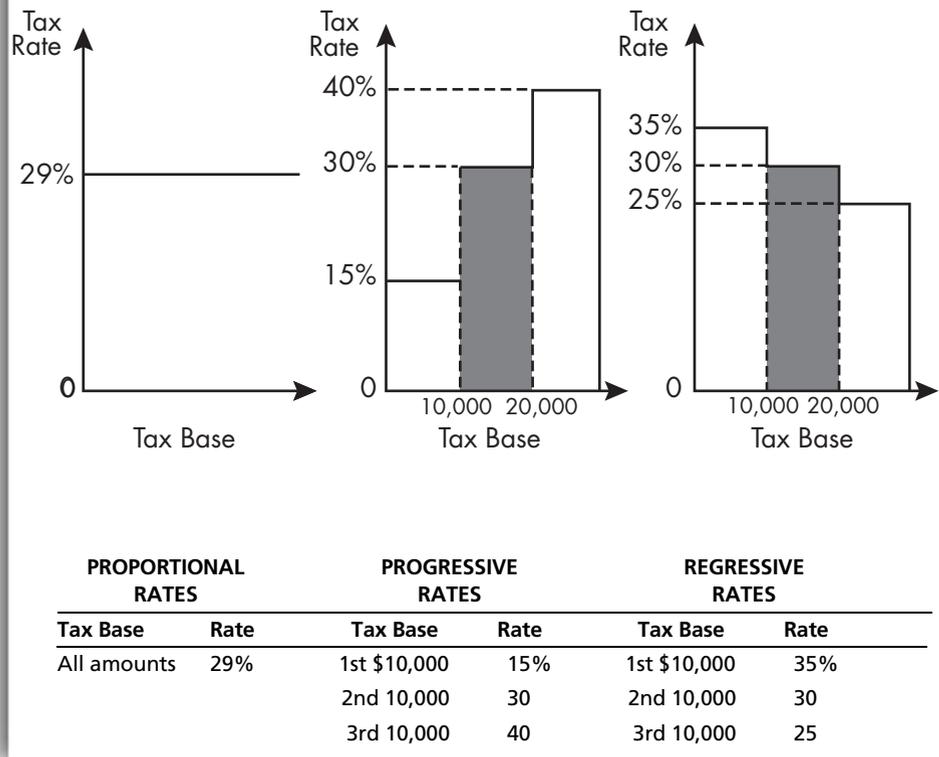
## Tax Rates

Most tax scholars identify three distinct tax rate structures: proportional, progressive, and regressive, as illustrated in Exhibit 12-1. The classification of a rate structure depends on the trend of the tax rate as the tax base increases. Under a **proportional tax rate** system, the tax rate is constant; for example, it might stand at 29 percent of net wealth, over all possible values of the tax base. Most American sales and property taxes employ a proportional rate structure. Under a tax system with **progressive tax rates**, the applicable tax rate increases as the tax base grows larger. American income, estate, and gift taxes typically use nominally progressive rates. Finally, the tax rate decreases as the tax base grows larger under a system of **regressive tax rates**. Using the present scheme of classification, no significant American tax to date has employed a system of nominally regressive tax rates.

**Example 12-4** In the typical year, Social Security taxes are imposed on employees at a flat rate (before credits), say, of 8 percent on all wages up to \$110,000. For wages in excess of \$110,000, there is no additional tax. Technically, this tax is proportional, because all covered wages (the tax base) are subject to the same rate of tax. However, many people regard Social Security taxes to be regressive, presumably because they tend to relate their analysis to all of one's income and not just to the statutory tax base. Under this view, because the marginal tax rate is zero on wages in excess of \$110,000 for the year, the tax is both effectively and nominally regressive.

Many taxpayers confuse the appropriate meaning of their **marginal tax rate**. Typically, they assume that if a taxpayer is subject to a 36 percent marginal tax rate

**Exhibit 12-1: Alternative Tax Rate Structures: Graphic Illustrations and Applicable Schedules**



(i.e., 36 cents is payable in tax on the next dollar of taxable income), he or she owes 36 percent of the *entire* taxable income. One often hears people fall victim to this fallacy, when they state, “I wish I hadn’t gotten that raise, because it threw me into a higher tax bracket!” The truth is that even under a system of progressive tax rates, one is never left worse off by earning more money. The higher marginal rates that apply to additional income affect only those increments; the tax liability on the original income layers does not change.

Such comments reflect a confusion on the part of the taxpayer concerning marginal tax rate and average tax rate. The **average tax rate** is a simple division of the total tax liability by the corresponding tax base.

**Example 12-5** Lydia earned \$50,000 this year. After applying various deductions, exclusions, and exemptions, though, Lydia’s statutory taxable income is \$41,000; further, the middle tax rate system of Exhibit 12-1 is in effect. Lydia’s tax is computed as follows.

$$\begin{array}{r}
 15\% \times \$10,000 = \$ 1,500 \\
 30\% \times 10,000 = \quad 3,000 \\
 40\% \times 21,000 = \quad 8,400 \\
 \hline
 \text{Tax liability} \quad \quad \$12,900
 \end{array}$$

Lydia’s marginal tax rate is 40 percent, but her average rate is only 31.5 percent (\$12,900 tax due ÷ \$41,000 taxable income).

The reader should make sure that he or she understands this distinction between marginal and average tax rates, because all tax planning analyses should be based on

**Exhibit 12-2: Various Tax Rate Computations Illustrated**

Lydia files a tax return for \$50,000 of economic income and \$9,000 of exemptions, exclusions, and deductions. Taxable income is \$41,000. Tax liability is \$12,900 under the prevailing rate system.

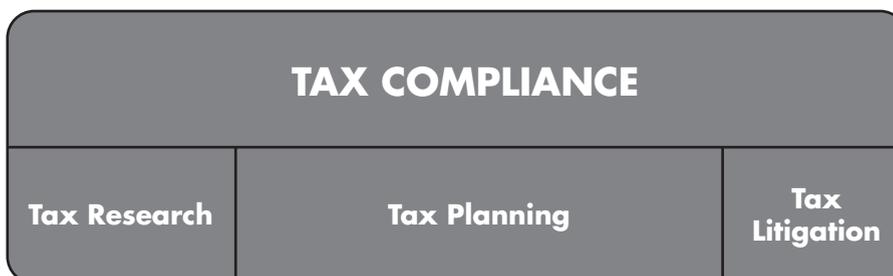
<b>Marginal tax rate</b>	40% (from tax rate schedule, middle system, Exhibit 12-1)
<b>Average tax rates</b>	Nominal average rate: $\$12,900/\$41,000 = 31.5\%$
	Effective average rate: $\$12,900/\$50,000 = 25.8\%$

the marginal tax that the individual will pay or save by adopting a particular course of action. The average tax rate is an interesting statistic, but it is solely the marginal rate that affects the change in tax liability and any corresponding changes in taxpayer behavior.

Of course, this definition of statutory taxable income allows for certain deductions, exemptions, and exclusions from total receipts in determining the tax base for the year. Often, because one has received tax-exempt income during the period and because of the tax base's exemptions and standard deduction, an individual controls more receipts than he or she legally must report as taxable income. In this case, the distinction between the nominal and effective average tax rates becomes important. The **nominal average tax rate** can be computed in Example 12-5 as the division of total tax liability by taxable income (i.e., 31.5 percent). However, before considering Lydia's exclusions, exemptions, and deductions, effectively she had command over \$50,000 of income during the year, even though only \$41,000 of this amount was defined technically as taxable income. Thus, Lydia's **effective average tax rate** of tax for the year can be found by dividing the total tax liability by "total," or economic, income. Here, the effective average rate of tax is only  $\$12,900 \div \$50,000 = 25.8$  percent. Exhibit 12-2 summarizes the various tax rate computations that have been introduced in this section.

**TAX PLANNING IN PERSPECTIVE**

The entrepreneurial tax professional should not see tax planning as an end in itself. Rather, especially when dealing with individual clients, tax planning must be seen as part of two sets of major services provided by the practitioner, as illustrated in Exhibits 12-3 and 12-4. As we discussed in Chapter 1, tax planning is part of the

**Exhibit 12-3: Tax Planning in the Typical Tax Practice, by Time and Effort of the Professional Staff**

**Exhibit 12-4: Tax Planning in the Client's Wealth Planning Process**

<b>EDUCATION PLANNING</b> Trusts for Minors Special Investments		<b>ESTATE PLANNING</b> Asset Management Distributions and Control	
<b>RETIREMENT PLANNING</b> Qualified Plans Nonqualified Plans Distributions Plans and Vehicles	<b>INCOME TAX PLANNING</b> Timing Tax Entity Exclusions and Deductions Income Classification Special Taxes Withholding Interest and Penalties	<b>INVESTMENT PLANNING</b> Risks Rewards Control Purchases/Sales Asset Allocation Regulations	
<b>CASH PLANNING</b> Budgeting Finance		<b>RISK PLANNING</b> Insurance Security	

entire menu of tax services that the tax professional makes available. Although the compliance and litigation aspects of the profession increasingly are shared with paraprofessionals (who prepare the bulk of tax returns for many professional firms) or attorneys (when a seemingly irresolvable conflict arises, usually between the client and the IRS [Internal Revenue Service]), tax planning rightly is initiated by the well-educated and experienced tax practitioner.

Similarly, tax planning is but one of the various types of planning services that a tax professional offers to clients. As the U.S. population collectively ages, the importance of portfolio, estate, and retirement planning has increased. As the “baby boom echo” materialized in the early part of the twenty-first century, education planning again took center stage. Planning for cash and risk contingencies is mandatory for business clients, but even the most modestly endowed of individual clients can benefit from an introduction to such planning.

Thus, to the extent that the tax professional offers tax planning and counseling services, he or she must be facile with the rudiments of the planning process and with the dynamic nature of the evolution of the tax law as it affects planning engagements.

## FUNDAMENTALS OF TAX PLANNING

As we noted in Chapter 1, tax planning is a completely legal means for saving taxes.<sup>2</sup> The basic objective of such planning is to arrange one's financial activities in a way that will reduce the present value of tax costs, such that maximum wealth accumulation can occur in the time period specified.

<sup>2</sup>Portions of this section are adapted from William A. Raabe and James E. Parker, *Tax Concepts for Decision Making* (St. Paul, MN: West Publishing Co., 1985).

Opportunities for effective tax planning almost always are greater when tax effects are given consideration before transactions are finalized, rather than after they are completed. Decision makers should constantly be alert for tax-optimizing alternatives in the everyday conduct of their affairs. In other words, the first requirement for effective tax planning is **tax awareness** on the part of decision makers, rather than tax expertise by tax professionals.

**Example 12-6** Russell and Phyllis Cohen, a married couple subject to a 30 percent marginal tax rate, currently are negotiating the purchase of their first home with the Hacienda Heights Construction Company, a land developer. The company has offered to sell the Cohens a selected house and lot at a price of \$60,000, with a 20 percent down payment and 10 percent interest on annual payments over a five-year period. Under these terms, payments would be as follows.

Year	Beginning Balance	Interest	Principal	Total payment
0	\$60,000	\$ —	\$12,000	\$12,000
1	48,000	4,800	7,862	12,662
2	40,138	4,014	8,648	12,662
3	31,490	3,149	9,513	12,662
4	21,977	2,198	10,464	12,662
5	11,513	1,151	11,513	12,664
Totals		<u>\$15,312</u>	<u>\$60,000</u>	<u>\$75,312</u>

The Cohens are aware that mortgage interest payments are tax-deductible and that the purchase price of a home is not. Thus, they make a counter-offer to purchase the home at a price of \$54,445, with \$12,000 down and 15 percent interest on annual payments over a five-year period. Under these new terms, Hacienda Heights receives the same cash payments (and gross income) as it did under the original terms. However, the amount of allowable deductions to the Cohens would be increased, with no change in total cash payments.

Year	Beginning Balance	Interest	Principal	Total payment
0	\$54,445	\$ —	\$12,000	\$12,000
1	42,445	6,367	6,295	12,662
2	36,150	5,423	7,239	12,662
3	28,911	4,337	8,325	12,662
4	20,586	3,088	9,574	12,662
5	11,012	1,652	11,012	12,664
Totals		<u>\$20,867</u>	<u>\$54,445</u>	<u>\$75,312</u>

These results are not uncommon in a robust tax planning context. Often, decision makers can benefit by recognizing how the rearrangement of a planned transaction can produce tax savings, even if the economic substance of the transaction is left unaltered (or altered very little). The key, of course, is to pay close attention to the structural and transactional categories that have been established by Congress and the courts. In Example 12-6, by reclassifying a portion of their housing expenditures as (deductible) interest rather than (nondeductible) principal, the Cohens were able to increase their allowable deductions and save taxes. Stated differently, the taxpayer's ability to conceptualize actions or events within stated legal definitions is of utmost importance.

**Exhibit 12-5: Goals of Tax Planning Behavior**

- Avoiding statutory income, obtaining deductions and credits
- Postponing income recognition, accelerating losses, deductions, and credits
- Changing tax jurisdictions
- Controlling the classification of income
- Spreading income among related taxpayers

Tax planning behavior can be characterized as falling into one or more of the general categories enumerated in Exhibit 12-5. Virtually every tax planning technique employed by the tax professional fits one or more of these overriding planning objectives.

**SPOTLIGHT ON TAXATION****Radical Tax Planning**

"A well-timed death is the acme of good tax planning, better even than a well-timed marriage."

—(Former IRS Commissioner) Donald C. Alexander

**Avoiding Income Recognition**

Taxpayers often can reduce their exposure to taxation by avoiding the accumulation of gross income that must be recognized. This is not to suggest that a taxpayer should avoid accumulating real economic income. As long as marginal tax rates remain less than 100 percent, few people would be willing to go to that extreme. Rather, one usually should strive to obtain economic wealth in some manner that does not create recognized income under the tax law.

**Example 12-7** Julie earned \$3,500 when she sold the crop of fruits and vegetables that she grew, and she was subject to income tax on the full amount. Warren also grew a crop of produce of the same size, but he and his family ate the food. Thus, Warren recognized no gross income and paid no income tax relative to his gardening activities, but his family enjoyed \$3,500 worth of fruits and vegetables.

Another method by which one can avoid obtaining recognized income is through the use of debt. Since neither the borrowing of money nor the receipt of funds that previously were lent generates gross income, taxpayers sometimes can use loans to avoid the recognition of taxable income on appreciated investments and enjoy the temporary use of the cash.

**Example 12-8** Doug owns a tract of land that he acquired many years ago for \$10,000. Currently, the land is worth \$100,000. Doug needs \$50,000 cash for a business venture. He is considering two alternatives: one is to sell half of the land and the other is to borrow the \$50,000 by giving a mortgage on the land.

If Doug sells one-half of the land, he will recognize a \$45,000 (\$50,000 – 1/2 of \$10,000) taxable gain. However, Doug recognizes no taxable income if he borrows the money, even though the amount that he borrows will be in excess of the basis of the land.

**Example 12-9** Barbara Ward formed a new corporation by investing \$100,000 cash. Following the advice of her tax consultant, Barbara designated \$60,000 to be used for the purchase of corporate stock and \$40,000 as a loan to the corporation. In this way, if Barbara wants to receive large amounts of cash back from the corporation in the future, the entity simply will repay part or all of the loan principal to her, tax free, rather than making a large (taxable and non-deductible) dividend payment. Barbara also can direct the corporation to pay interest on the loan; such payments are deductible by the corporation. Of course, both interest and dividends are taxable to Barbara when she receives them.

Still another, and perhaps more obvious, way in which one can avoid the recognition of income for tax purposes is to take advantage of the many exclusions that the law permits. For example, an employee might arrange to receive certain nontaxable fringe benefits (such as health insurance) from the employer, in lieu of an equivalent value in (taxable) cash salary. This relationship should affect all negotiations as to compensation arrangements: the employer is indifferent between the two choices because both salary and fringe benefit payments are fully deductible against gross income, but the employee's after-tax wealth increases more where tax-free benefits are received.

**Example 12-10** Lee Schrader, who is subject to a 40 percent overall marginal tax rate, is better off if she receives a tax-free fringe benefit than if she receives an equivalent raise in her salary.

	<b>If Salary Increases</b>	<b>If Fringe Benefit Is Chosen</b>
Value of compensation received	\$2,000	\$2,000
Tax on employee's compensation	<u>– 800</u>	<u>–</u>
After-tax increase in employee's wealth	<u>\$1,200</u>	<u>\$2,000</u>

### Postponing Income Recognition

By delaying the recognition of income, one also delays the payment of the tax and, hence, can continue to enjoy the use of that tax money. Given the relatively high interest rates that are anticipated in coming years, this delay takes on increased importance. At 6 percent annual interest, the present value of a \$1,000 tax that is postponed for ten years is only \$558, a “forgiveness” of almost one-half of the tax “cost.” For longer periods and/or higher interest rates, the economic significance of the delay would be even greater. Appendix A includes a series of tables computing factors to reflect the time value of money.

**Example 12-11** Agatha Fraser paid \$1,000 for 750 Euros. At the same time, her sister, Betty, put \$1,000 into a U.S. bank savings account. By the current year, the value of Agatha's Euros had increased to \$1,800, and Betty's bank account had increased, due to interest accumulations, to the same amount. Since the increase in the value of the Euros was unrealized, Agatha had not been taxed yet on her \$800 increase in economic wealth. On the other hand, Betty's increase was realized from interest that was credited annually to her account.

Under the tax doctrine of *constructive receipt*, Betty had recognized gross income, accumulated over the nine-year planning period, of \$800.

**Example 12-12** Janie Heller owns land adjacent to her home that appreciated in value by \$5,000 this year. However, because she did not sell the land, the appreciation in market value was not realized in a market transaction or recognized for income tax purposes. Janie has no recognized income from the land for that year.

**Example 12-13** Janie Heller, of Example 12-12, paid interest of \$4,000 on a mortgage that was used to finance her home and land investment. Janie can deduct the interest amount to offset the income that she derived from other investment sources in computing her taxable income. In effect, Janie is able to achieve a deliberate mismatching of current-year costs and unrealized revenues.

**Example 12-14** Janie Heller, of Example 12-12, constructed an apartment building on her land, at a cost of \$500,000, of which \$475,000 was borrowed. By electing accelerated depreciation, which is based on the total \$500,000 cost of the building rather than on Janie's \$25,000 equity therein, Janie is able to take a depreciation deduction of about \$12,000 in the construction year alone, nearly equal to about one-half of her entire cash outlay for the current year.

## Changing Tax Jurisdictions

Tax systems are not universal in breadth, nature, or application. Taxes are adopted by governmental jurisdictions, to be collected from those who live and do business within their boundaries. Often, by moving assets or income out of one tax jurisdiction into another, tax reductions can be effected. Over time, governments tend to modify their tax systems to prevent the "leakage" of tax revenues through such cross-border transactions. Yet, in an effort to attract businesses and resulting jobs into their jurisdictions, governments often retain or create border incentives in the form of tax reductions that are limited in time or scope.

**Example 12-15** The island country of Ricardo meets its revenue needs with tariffs on the fishing industry. Ricardo never has adopted an income tax system. Harris, a U.S. corporation, could build its new assembly plant through a wholly owned subsidiary incorporated and doing business only in Ricardo, thereby reducing its costs of conducting business because there is no income tax on executive salaries or annual profits. Perhaps by design, Ricardo has attracted new business, profits, jobs, and other benefits through its tax policies.

**Example 12-16** State A includes in its statutory definition of taxable business income the interest paid on U.S. Treasury obligations. OneBank holds billions of dollars in Treasury notes, bills, and bonds, so, in an effort to reduce its tax costs, it creates a wholly owned subsidiary incorporated and doing business only in State B, which does not tax interest income. The subsidiary "repatriates" the interest to OneBank through quarterly dividend distributions, not taxed under the laws of State A. The economy of State A has been depleted because of its tax policy, but the taxpayer has responded with rational behavior in accord with its overall financial goals through judicious tax planning techniques.

## Controlling Classification of Income

For Federal income tax purposes, several distinct categories of income, deductions, and credits are recognized. The most important of these are (1) ordinary income, which is fully taxable, and ordinary deductions, which decrease the tax base dollar for dollar; (2) investment or “portfolio” income, which usually is fully taxable except for tax-exempt state and local bond interest, and related expenses, which typically can be subtracted only against investment income; and (3) income from passive activities, such as the ownership of rental or “tax shelter” assets, which usually is fully taxable, and related expenses, which can be subtracted only against passive income.

In addition, a fourth classification of income and expenses should be identified. If the taxpayer is subject to the alternative minimum tax (AMT), preference and adjustment items, such as accelerated depreciation deductions, may be included, and other expenditures may not be available as deductions.

Effective tax planning often includes the proper identification or reclassification of income or expenditure items, using these statutory definitions.

**Example 12-17** Phil Jankowski is the sole shareholder of a management consulting corporation. In addition, he has invested in tax shelter entities that are generating \$40,000 per year in passive losses for him. According to the Code, such losses from passive activities cannot be applied as deductions to offset fully taxable income, for example, from Phil’s salary or capital gain transactions. Accordingly, Phil cannot reduce current taxable income by the \$40,000 passive loss from his tax shelter.

As the dominant shareholder of his corporation, however, Phil may be in a position to salvage the \$40,000 deduction. If he reduces his salary from the corporation by \$40,000 and takes instead from the corporation a \$40,000 properly structured lease payment for the use of specified personal or real property that he owns but the corporation uses, such as office equipment or automobiles, he may be able to create \$40,000 in passive income from rental activities, against which the tax shelter loss can be offset.

**Example 12-18** Matt Young Eagle is subject to the AMT for the first time ever this year because he exercised the incentive stock options of his employer. Nonbusiness taxes paid and miscellaneous itemized deductions, among other familiar items, are not allowed as deductions when computing AMT income. Only certain tax credits are allowed against the AMT. Accordingly, Young Eagle should defer the payments of his fourth-quarter state income tax estimates and of the real estate tax on his home until next year, when the usual definitions of taxable income will apply to him again.

## Spreading Income among Related Taxpayers

Because different types of legal entities are taxed separately and at different rates, an individual often can produce an overall tax savings by conducting various business and investment activities within separate taxpaying entities. The progressive nature of the various tax rate schedules further tends to increase the advantage of income splitting. This benefit might result from shifting income, either among different economic entities that are owned by the same individual or among the individual’s family members. Accordingly, tax considerations often play an important role both in the selection of organizational forms for a business enterprise and in family financial arrangements.

**Example 12-19** Bob and Lorraine Whitehead are currently providing for Lorraine's parents' retirement out of after-tax income. Given the Whiteheads' marginal income tax rate of 30 percent, \$1,000 of pretax income is needed to produce \$700 of savings [ $\$1,000 - (0.30 \text{ of } \$1,000) = \$700$ ]. Assuming that the parents have a marginal income tax rate of only 18 percent, a transfer to them of \$1,000 of pretax income, say, by the placement of income-producing assets into an appropriate trust, would raise the after-tax contribution to the parents' retirement to \$820 [ $\$1,000 - (0.18 \text{ of } \$1,000)$ ].

**Example 12-20** Sally Campbell is the sole shareholder and only employee of the Newark Corporation. The corporation's operating income this year is expected to be \$125,000. Sally is subject to an overall marginal income tax rate of 30 percent. Sally wishes to know, considering only the Federal income tax, what amount of salary payments to her would produce the smallest combined tax for both herself and the corporation. Sally's income from other sources is sufficient to meet her living expenses and it precisely equals her total income tax deductions, so her taxable income is exactly equal to any salary that she receives from the corporation.

Currently, marginal corporate income tax rates do not exceed the 30 percent marginal individual tax bracket until corporate taxable income is greater than \$75,000. Accordingly, the tax adviser should be certain to plan the corporation's compensation policy so that a corporate taxable income of at least \$75,000 exists every year.

## DEPARTING FROM THE FUNDAMENTALS

The general principles of tax planning that have been presented usually produce an optimal tax liability for the taxpayer. However, unusual circumstances may dictate that such principles should be violated purposely, to produce a desired effect. Again, however, the tax awareness of the parties is utmost in proper planning activities.

**Example 12-21** Gretchen's manufacturing business is unincorporated. It has generated an operating loss of \$265,000, which Gretchen can deduct on her tax return. Although there may be other tax uses for this loss, Gretchen may want to accelerate the recognition of other gross income into the current year, for example, by selling appreciated investments, exercising more sophisticated tax accounting elections, or simply sending out bills to customers in a more timely fashion. Economically, such income has been earned gradually by Gretchen, but it has had no tax effect yet because it has not been realized. Realization this year, however, will result in no tax liability for Gretchen because of the loss, so income acceleration should be considered.

**Example 12-22** Brian's gross income is lower than he expected because of an unanticipated decrease in the sale of his homemade sandals. From a tax standpoint, it may be better to delay deductible expenditures of a discretionary or personal nature (e.g., advertising, medical expenses, and charitable contributions) until business picks up again. In this manner, the value of such deductions will increase, as will the marginal income tax rate to which he is subject.

**Example 12-23** Dolores is subject to the AMT this year, so her marginal tax rate is 24 percent, not the usual 36 percent. She might consider accelerating some gross income into the current year to take advantage of this structural decrease in her marginal tax rate. The tax adviser must be certain, though, to compare the present values of the resulting taxes, not just the nominal dollar amounts (i.e., the proper tax planning comparison is between the \$32,400 and the \$24,000), and Dolores should accelerate the gross income in this setting.

	<b>If Regular Tax Applies, Taxed Next Year</b>	<b>If AMT Applies, Taxed This Year</b>
Nominal tax liability	\$36,000	\$24,000
Present value of tax liability	32,400	24,000



## SPOTLIGHT ON TAXATION

### Fruits of Tax Planning

“Tax planning is driven by the fact that under a non-neutral tax law, transactions or arrangements whose economic differences are minor can have significantly different tax consequences.”

—James W. Wetzel

## EXPLOITING INCONSISTENCIES IN THE STATUTE

Sometimes, especially when the tax planner can affect the behavior of more than one taxpayer, the tax planning goals can be accomplished by exploiting perceived inconsistencies in the tax system. Multiple taxpayers can exist in the form of family members or related corporations and their shareholders. Several types of systemic inconsistencies can be identified and used by the tax planner.

### Inconsistencies between Transactions

Most forms of self-provided in-kind income go unrecognized for tax purposes. Often, the same items are not deductible, however, when they are purchased in market transactions. Thus, providing for one’s own needs can be an important technique in managing the recognition of taxable income.

**Example 12-24** Jerry has \$50,000 in savings. If the money were invested in securities, the yield on his investment would be taxable, although no deduction would be allowed for his “personal” expense of renting a home. If the \$50,000 were invested in a home for his own use, however, the net rental value of the home would escape taxation, since such in-kind value is not recognized as gross income under the law.

### Inconsistencies between Taxpayers

Inconsistencies often exist between Code sections that control the recognition of income and those that control the allowance of deductions for the same items. When a transaction is between related taxpayers, such inconsistent treatments

sometimes can be used to the taxpayers' advantage. The objective in such a situation usually is to structure the terms of the transaction so as to decrease taxable income to the taxpayer group as a whole.

**Example 12-25** Marilyn is the sole owner-employee of a corporation. To the extent that the corporation pays dividends to Marilyn, she will recognize gross income, but the corporation will receive no deduction. To the extent that Marilyn is paid a reasonable salary, she will recognize gross income and the corporation will receive a deduction. To the extent that she receives certain employee fringe benefits, such as medical insurance, Marilyn is not required to recognize taxable income, and the corporation is allowed an ordinary business expense deduction. In summary, the payment of dividends increases combined taxable income of a shareholder and the corporation, the payment of salary does not change combined taxable income, and providing qualified fringe benefits reduces combined taxable income.

**Example 12-26** Don and Ann Evans operate a farm, producing a net taxable income of about \$30,000 per year. Their nondeductible expenses for housing average \$12,000 per year.

The Evanses should consider forming a corporation and making a tax-free transfer of all of the farm property to the corporation, including their personal living quarters. As shareholders of the corporation, they could hire themselves as employees, with a requirement that they live on the business premises. The value of the lodging would not be taxable to the Evanses as individuals, under §119 of the Code, but it would be deductible as a business expense of the corporation, thus reducing the corporation's taxable income before salaries to \$18,000 (\$30,000 - \$12,000).

The Evanses then should have the corporation pay them reasonable salaries totaling \$18,000. In this manner, taxable income of \$18,000 would be taxed directly to them as individuals, and the corporation's taxable income would be reduced to zero, thus avoiding any double taxation. By using this combination of income splitting and an employee fringe benefit, the Evanses could effectively reduce their taxable income (i.e., from \$30,000 to \$18,000) by the amount of their lodging costs (\$12,000), even though such costs are generally nondeductible by both self-employed persons and employees.

This result is based on the assumptions that \$18,000 is a reasonable salary for the work that they perform, and that the requirement for living on the farm is for a bona fide business purpose (other than merely for tax avoidance).

### **Inconsistencies between Years**

Another form of inconsistency concerns timing differences in the recognition of income and deductions. Such inconsistencies may relate to the transactions of one taxpayer, or they may concern two taxpayers engaging in a single transaction. In both cases, careful planning to take advantage of tax law inconsistencies can result in a considerable delay in the payment of taxes.

**Example 12-27** Sarah Carter uses borrowed funds to acquire nondividend-paying corporate stocks. Appreciation on the stocks is not taxed until it is realized on the sale of the shares; yet, Carter might be able to claim investment-interest deductions for the interest that she pays on the borrowed funds.

**Example 12-28** Harry Fischer is a 40 percent shareholder and junior executive of Able Corporation. Harry's performance incentive bonus is set at 30 percent of the corporation's pretax earnings for the year. It is payable on January 31 of the following year.

Because the corporation is an accrual-basis taxpayer, the bonus is deductible in the year in which it is earned. As a cash-basis minority shareholder, however, Harry need not recognize the income until the following taxable year (i.e., when he receives it). To the extent of Harry's bonus, the recognition of combined corporate and shareholder income thus is delayed for one year.

**Example 12-29** Jane Summer is an employee of Orange Corporation and is covered by the company's qualified pension plan. The corporation makes a contribution to the plan for Jane's retirement, which will occur in thirty years. Although Jane will not receive any gross income from the pension benefits until her retirement in thirty years, the corporation is entitled to a current-year business expense deduction.

## AVOIDING TAX TRAPS

Ever since the enactment of the first income tax law, taxpayers have been trying to find ways to avoid such taxes. Likewise, Congress, the IRS, and the courts have enacted rules and doctrines to prevent, or at least restrict, various avoidance schemes. As a result, current tax law includes a maze of tax traps for the unwary.

### Statutory Tax Traps

Many of the statutory provisions encountered in a tax planning context can best be understood when they are viewed as preventive provisions, that is, as rules designed by Congress to prevent certain techniques of tax avoidance. However, remember that any transaction that falls within the scope of a given provision, whether or not it is intended as part of a tax avoidance scheme, is subject to that provision. Thus, a basic knowledge of the tax system is necessary for the tax planner if certain disastrous pitfalls are to be avoided.

As we noted earlier in this chapter, income splitting between related taxpayers often can generate significant tax savings. To be effective for tax purposes, though, the income actually must be earned by the separate entities and not merely assigned by means of artificial transactions between them. Section 482 gives the IRS the power to reallocate both income and deductions among certain related taxpayers so as to reflect "true taxable income."

In applying §482, the regulations indicate that the IRS's right to determine true taxable income is not limited to fraudulent or sham transactions, but also situations where income inadvertently has been shifted between controlled parties. The courts have held, however, that there truly must be a "shifting" of income before the IRS's power comes into play. Bona fide business transactions that bring tax advantages in their wake should not subject the related parties to reallocation. In concept, at least, §482 can be applied by the IRS only where there has been some manipulation of income or deductions by the taxpayers.

Thus, while its boundaries are, in practice, both broad and sometimes hazy, §482 does not prohibit the use of multiple entities for the purpose of earning income. It does, however, give the IRS a potent weapon with which to combat the artificial shifting of income between those entities.

**Example 12-30** X and Y are two corporations that are fully owned by the same individual. X operates an international airline, and Y owns several hotels that are located in cities served by X. In conjunction with the advertising of its airlines, X often pictures Y's hotels. Although the primary benefit of the advertising is to X's airline operations, Y's hotels also obtain patronage by travelers who respond to the ads. X does not charge Y for the advertising. Because an unrelated hotel operator presumably would have been charged for such advertising, the IRS may make an allocation of income from X to Y to reflect the fair market value of the advertising services that were provided.

The Code restricts the amount of unearned income that can be taxed at the (lower) marginal rates of one's dependent nonstudent child who has not yet attained age nineteen to less than \$1,800 per year, an amount indexed for inflation. Any unearned income of the child that exceeds this amount is taxed to the child, but at the (higher) marginal rates of his or her parents. The purpose of this portion of the *Internal Revenue Code* is not to discriminate against children (who probably cannot vote in congressional elections), nor to place a higher tax burden on interest and dividend income, nor even to make the family the chief taxable unit in this country. Rather, the provision was enacted simply to discourage the shifting of taxable income from the higher tax brackets of the parent, through a temporary trust or some other accepted income-shifting vehicle, to the more favorable rates of the child, without any permanent loss by the parent of control over the use of the asset. Such tax planning techniques had been undertaken for many years, as a means (similar to that of Example 12-19 for older related individuals) of accumulating after-tax contributions to an educational fund, by transferring income to the lowest marginal tax rates that were available within the family.

Whereas the objective of this part of the statute may be defensible by some, the broad provision that was enacted to implement it may create undue hardships in some circumstances, because it affects all taxpayers, not only those with the now-forbidden income-shifting motivation.

**Example 12-31** Jimmy, age seven, received an inheritance from his grandmother's estate last year. Grandmother wanted Jimmy to attend a good graduate program in taxation someday, so she invested in high-income securities that produce about \$22,000 in interest income annually. Jimmy's parents are to see that he accumulates this income for his education. The interest will be taxed at the parents' 40 percent marginal rate, however, and not at Jimmy's (zero and) 15 percent rate, so a smaller after-tax amount of this income will be available for this laudable educational purpose.

## Judicial Tax Traps

In the final analysis, the words of the tax law mean only what the courts say that they mean. Often, judicial decisions must be consulted to determine the allowable limits of various Code provisions.

**Example 12-32** An employee-shareholder of a 50 percent family-owned corporation received an annual salary in excess of \$1 million, an amount greater than that then paid to the heads of such corporations as General Motors and Sears.<sup>3</sup> Yet, despite IRS arguments to the contrary, the Tax Court upheld the

<sup>3</sup>*Home Interiors and Gifts, Inc.*, 73 T.C. 92 (1980).

entire amount paid as “reasonable” under the circumstances of the case because of the special talents and abilities that the employee brought to the corporation.

**Example 12-33** A widow changed her will to disinherit her relatives and leave her assets to her attorney and his wife.<sup>4</sup> When the widow died, her relatives brought suit against the attorney, alleging that he had influenced the widow improperly through a personal relationship with her. The attorney paid them \$121,000 to withdraw their litigation and deducted the payment as a business expense. The Tax Court upheld the deduction on the grounds that the payment was made for the purpose of maintaining the professional reputation of the attorney.

On appeal, the Tax Court’s decision was overturned. According to the appeals court, a taxpayer’s reasons for paying do not determine whether the payment is deductible. Because the lawsuit arose from the attorney’s personal relationship with the widow, the \$121,000 settlement was deemed to be a personal, nondeductible cost.

**Example 12-34** Housing is expensive in Japan. A unit of a large oil company owned the house that was used by its president, at his discretion, when he stayed in Japan.<sup>5</sup> The house would have rented for \$4,400 a year in the United States, but in Tokyo its annual rental value was \$20,000. The executive included it in income and paid tax on \$4,400, the U.S. rental value. However, the IRS asserted that the full \$20,000 should have been included in his gross income.

The U.S. Court of Claims agreed with the taxpayer, holding that the excess rental value was primarily of benefit to the company, rather than to the individual. The home’s prestige value was held to be important to the employer because of social values that were peculiar to Japan, where, in the words of the court, “‘face’ is an almost tangible reality.”

Two pervasive judicial doctrines that often limit the taxpayer’s ability to employ effective planning techniques are the concepts of *business purpose* and *substance over form*. To be upheld for tax purposes, transactions must possess some nontax, or “business,” purpose in addition to that of tax avoidance. Moreover, there is always the possibility that the court may ignore the form of a transaction if it perceives that such structural false colors cloud the actual substance of the arrangement.

Whenever a series of transactions results in significant tax savings, the IRS may attempt to apply the concept of substance over form by “telescoping” or “collapsing” several transactions into one. If it is upheld by a court, this *step-transaction doctrine* sometimes can negate what had been a good tax plan (where the steps were viewed as separate transactions). To guard against this possibility, the taxpayer should have a bona fide business purpose for each individual step in the transaction. Of course, documenting nontax purposes is usually much easier if the various transactions are separated by reasonable time spans, since they are then less likely to be viewed as component parts of an overall plan.

**Example 12-35** Sandra is the sole shareholder of a real estate development corporation. On January 15, she purchased ten additional shares of stock from her corporation for \$100,000. On the same day, she sold a tract of undeveloped

<sup>4</sup>*William J. McDonald, Jr.*, 592 F.2d 635, 78-2 USTC ¶ 9631, 42 AFTR2d 78-5797 (CA-2).

<sup>5</sup>*Faneuil Adams*, 585 F.2d 106, 77-2 USTC ¶ 9613, 40 AFTR2d 77-5607 (Ct.Cl.).

land to the corporation for its fair market value of \$100,000. To the corporation, the land will be inventory. For Sandra, it had been a capital asset, having been held for investment purposes since its purchase ten years previously for \$20,000. If these events are viewed as two separate transactions, Sandra will have increased the basis of her investment in the corporation by \$100,000 and realized a fully taxable capital gain of \$80,000 (\$100,000 – \$20,000). The corporation’s basis in the land will be \$100,000. Thus, if the corporation were to sell the land for, say, \$110,000, its income therefrom would be only \$10,000 (\$110,000 – \$100,000).

Alternatively, if these events are collapsed into a single transaction, Sandra’s payment and receipt of cash would be ignored. Instead, she would be viewed as having given a tract of land in exchange for ten shares of stock of a corporation that she already controls. Under this single-transaction view, Sandra would recognize no taxable capital gain, and the corporation’s basis in the stock would be the same as her prior basis, \$20,000. Thus, if the corporation were to sell the land for \$110,000, its ordinary income would be \$90,000 (\$110,000 – \$20,000).

Taxpayers are restricted to the actual legal forms of the transactions in which they engage, but the IRS has the option of employing the step-transaction doctrine. Thus, the lack of any time lapse between the two transactions effectively gives the IRS its choice as to which interpretation it wishes to follow.

## TAX PLANNING ILLUSTRATIONS

Consider several other examples of tax planning that are found in today’s tax practice. Usually, a tax planning technique manifests at least one of the planning goals as listed in Exhibit 12-5. The best techniques meet two or more of those goals.

**Example 12-36** Albert contributes the maximum amount for the year to a \$529 education plan for his daughter. No immediate deduction is allowed, but the earnings in the account never are taxed. Withdrawals similarly are excluded from gross income when they are used for education-related expenses. Result: *Avoiding statutory income.*

**Example 12-37** Phil designates a portion of his monthly paycheck for medical and child care expenses. No payroll taxes are due on these amounts. Phil’s employer reimburses him from these funds when it receives documentation from Phil that he incurred medical and babysitting expenses for the period. By using a “flexible spending plan” such as this one, Phil reduces his total tax liability and has more discretionary income for the year. Result: *Avoiding statutory income.*

**Example 12-38** Mary Jane uses a depreciable asset in her business to generate net sales at a profit. The depreciation deductions shelter current sales income from tax, but because the tax basis of the asset is reduced accordingly, there is a greater gain computed when Mary Jane sells or retires the income-producing asset. Result: *Postponing income recognition.*

**Example 12-39** Judy keeps a log of her travels so that she can document that she is a resident of Texas, not New York. As a result, Judy’s state income tax liability is reduced significantly every year. Result: *Changing tax jurisdictions.*

**Example 12-40** Because she is a citizen of the Cayman Islands and not the United States, Ingrid is subject to very low marginal estate and gift tax rates on her extensive portfolio and collectible holdings. Result: *Changing tax jurisdictions.*

**Example 12-41** Fizzy Corporation holds some vacant land for potential expansion of its operating plant. By paving asphalt over the land and turning it into a parking lot, charging its executives a nominal fee so that they can park closer to their offices, Fizzy converts portfolio gain into passive income, which frees up deductions now suspended under the passive activity rules. Such passive income is taxed, however, only when Fizzy unilaterally decides to sell the vacant land. Result: *Controlling income classification. Postponing income recognition.*

**Example 12-42** Ralph forms a partnership that borrows money and purchases an office building in Texas, which is the home state of none of the partners. The entity passes through net operating losses, made up chiefly of interest and depreciation deductions, which the partners use to offset their passive income from other sources. When the building is sold, state and local income and property taxes are relatively low under Texas law. Result: *Avoiding statutory income. Postponing income recognition. Changing tax jurisdictions. Controlling the classification of income. Spreading income among related taxpayers.*

**Example 12-43** Carolyn sets up a charitable lead trust, under which the museum receives the trust's distributable net income for fifteen years. Carolyn receives an immediate charitable contribution deduction, equal to the present value of the income stream that she has transferred to the museum. Then, the income-producing property of the trust is deeded to Carolyn's daughter, thereby likely deferring any estate tax on the property for another twenty-five years. Result: *Avoiding statutory income. Postponing income recognition (and transfer tax). Spreading income among related taxpayers.*

**Example 12-44** George renovates a downtown warehouse and turns it into condos and apartments. Because the building has some historic significance, George undertakes the rehabilitation so as to maximize his state and Federal tax credits for rehabilitation expenditures. Result: *Controlling income classification. Avoiding statutory income (creating tax credits).*

**Example 12-45** Richie makes certain that he makes gifts every year of \$12,000 to each of his relatives, thereby using the entire statutory annual gift tax exclusion. Result: *Avoiding statutory income (using transfer tax exclusions). Spreading income among related taxpayers.*

## SUMMARY

The study of taxes can be viewed as an examination of various ways to optimize one's tax liability. Tax rules that otherwise might seem as dry as a mouthful of sawdust have a way of becoming interesting, stimulating, and challenging when one realizes their

economic significance and the resulting implications on human behavior. Tax optimization, therefore, can be viewed both as the heart of professional tax work and as the most important aspect of taxation for nontax specialists.

## TAX TUTOR

Reinforce the tax research information covered in this chapter by completing the online tutorials located at the *Federal Tax Research* web site: <http://academic.cengage.com/taxation/raabe>

## KEY WORDS

By the time you complete this chapter, you should be comfortable discussing each of the following terms. If you need additional review of any of these items, return to the appropriate material in the chapter or consult the glossary to this text.

Average tax rate  
Effective average tax rate  
Marginal tax rate  
Nominal average tax rate

Progressive tax rates  
Proportional tax rate  
Regressive tax rates  
Tax awareness

## EXERCISES

1. Using the following codes, identify the basic approach(es) to tax avoidance that are used in each of the cases described below.
  - Av** = Avoiding income recognition
  - Cl** = Controlling the classification of income or expenditure
  - Ju** = Changing tax jurisdictions
  - Po** = Postponing income recognition
  - Sp** = Spreading income among related taxpayers
  - None** = None of the above
  - a. Albert invests his savings in tax-exempt state bonds.
  - b. Betty invests in nondividend-paying corporate stocks by using borrowed funds.
  - c. Chuck lends \$100,000 to his daughter on an interest-free demand note.
  - d. Doris lends \$10,000 to her son on a five-year note, bearing interest at the annual rate of 65 percent.
  - e. Ed invests \$100,000 of his savings in a home for his own use.
  - f. Frankie invests in a mutual fund that purchases only the indebtedness of the state in which he lives.
  - g. Grace invests in a mutual fund that purchases only the shares of U.S. corporations that pay no dividends, but whose share prices increase in value over a five-year time period.
2. Using the codes from Exercise 1, identify the basic approach(es) to tax avoidance that are used in each of the cases described below.
  - a. Annie invests in a mutual fund that purchases only the shares of Colonnia corporations, a country that has no tax treaty with the United States.
  - b. Burt moves his manufacturing plant to Mexico. Mexico has a tax treaty with the United States, but its labor and utility rates are much lower than is the case where Burt's Ohio plant now operates.

- c. Cheryl moves her manufacturing plant to Allegro. Allegro has no tax treaty with the United States, and its labor and utility rates are much lower than is the case where Cheryl's Ohio plant now operates.
  - d. Donna fails to report on her tax return the interest earned on her savings account.
  - e. Evelyn has her controlled corporation pay her a salary instead of a dividend during the current year.
  - f. Flip operates his business as a regular corporation because of his high marginal tax rate. He plans to sell the corporation in five years.
  - g. Georgia grows most of her own food instead of taking a second job.
3. With respect to the system of coding used in Exercises 1 and 2, create one new illustration in each tax planning category.
  4. How do taxes fit into the general economic goals of most taxpayers?
  5. How might a tax adviser ignoring the present value approach to tax planning arrive at an improper conclusion? Illustrate.
  6. Give some examples of U.S. taxes that employ proportional, progressive, and regressive rate structures.
  7. Give an example of a transaction between two taxpayers in which an inconsistent treatment is afforded the two taxpayers. Explain how related taxpayers might structure a transaction to take advantage of this inconsistency.
  8. Give an example to show when a taxpayer might consider shifting income from the ordinary classification to capital.
  9. Name two types of tax traps and give an example of each.
  10. How does the typical tax practitioner divide his or her time among planning, compliance, research, and litigation?
  11. What planning engagements can the tax professional offer? Why is he or she in an ideal position to offer these services?
  12. Summarize the most important planning services that a tax professional can offer to a client.
  13. Why does tax planning analysis focus on the marginal tax rate?
  14. When might a taxpayer undertake transactions seemingly opposite to the usual tax planning principles?
  15. Higher-income taxpayers tend to engage in tax planning more than do lower-income taxpayers. Why?
  16. Is the objective of tax planning always to minimize taxes? Explain.

## PROBLEMS

17. Examples 12-2 and 12-3 in the text concern a decision between the same two mutually exclusive alternatives under identical conditions, except for the

corporation's marginal tax rate. In Example 12-2, where the marginal tax rate was 40 percent, the conclusion was to accept Alternative A. In Example 12-3, where the marginal tax rate was 20 percent, the conclusion was to accept Alternative M.

Determine the marginal tax rate at which the two alternatives would be economic equivalents, that is, they would "break even" and generate the same excess after-tax payoff over after-tax cost. Your answer should be based on all of the conditions and assumptions as stated in Examples 12-2 and 12-3.

18. On creating a new 100 percent owned corporation, Ben was advised by his tax consultant to treat 50 percent of the total amount that was invested as a loan and 50 percent as a purchase of corporate stock. What tax advantage does this arrangement have over structuring the entire investment as a purchase of stock? Explain.
19. Julia currently is considering the purchase of some land to be held as an investment. She and the seller have agreed on a contract under which Julia would pay \$1,000 per month for sixty months or \$60,000 total. The seller, not in the real estate business, acquired the land several years ago by paying cash of \$10,000. Two alternative interpretations of this transaction are (1) a price of \$51,726 with 6 percent interest and (2) a price of \$39,380 with 18 percent interest. Which interpretation would you expect each party to prefer? Why?
20. George, a high-bracket taxpayer, wishes to shift some of his own taxable income to his 25-year-old daughter, Debra, and is considering two alternative methods of doing so. One is to make a gift of the interest on some corporate bonds that he owns. The other is to make her a gift of the full principal amount of the bonds. Evaluate the pros and cons of each alternative.
21. Betty Smith has two sons, Bob and Jack. List several tax planning techniques that would allow Betty to transfer her full ownership in the family dry cleaning business to Bob and Jack, maximizing the wealth of all four taxpaying entities (Betty, Bob, Jack, and the company).

## EXTENDED CASES

22. Should Ferris Corporation elect to forgo the carryback of its \$60,000 year 2008 net operating loss? Ferris is subject to a 15 percent cost of capital. Corporate tax rates are as in IRC §11.

a.

Tax Year	Actual or Projected Taxable Income
2007	\$700,000
2009	700,000

b.

Tax Year	Actual or Projected Taxable Income
2007	\$ 70,000
2009	700,000

c.

<u>Tax Year</u>	<u>Actual or Projected Taxable Income</u>
2007	\$ 70,000
2009	(70,000)
2010	(70,000)
2011	(70,000)
2012	700,000

23. Should Harris Corporation accelerate gross income into 2009, its first year subject to the AMT? Harris is subject to a 14 percent cost of capital. The corporate AMT rate is a flat 20 percent, and Harris exceeds the annual AMT exemption phase out.

a.

<u>Tax Year</u>	<u>Actual or Projected Taxable Income</u>
2010	Regular Tax \$700,000
2011	Regular Tax \$700,000

b.

<u>Tax Year</u>	<u>Actual or Projected Taxable Income</u>
2010	AMT \$700,000
2011	Regular Tax \$700,000

c.

<u>Tax Year</u>	<u>Actual or Projected Taxable Income</u>
2010	AMT \$700,000
2011	AMT \$700,000
2012	AMT \$700,000
2013	AMT \$700,000
2014	Regular Tax \$700,000

24. Paris Corporation holds a \$100,000 unrealized net capital gain. Should Paris accelerate the recognition of this gain, given a net capital loss carryforward in each of the following amounts? Paris is subject to a 14 percent cost of capital. Its marginal tax rate is 40 percent.
- \$40,000
  - \$10,000
  - Repeat parts a and b, but assume that Paris is subject to a 6 percent cost of capital
25. Maris Corporation put into service \$100,000 of equipment that qualifies for its state's 10 percent research credit. To the extent that the credit is claimed, no cost recovery deductions are allowed. Maris is subject to a 14 percent cost of capital. If the credit were not claimed, the property would qualify for cost recovery deductions using a three-year life, straight line with no salvage value, and a half-year convention. The state's flat income tax rate is as follows.
- 2 percent
  - 4 percent
  - 8 percent