

A note to you: These are my notes and I am happy to share them with you. They are not meant to be complete and they are not perfect. They are a work in progress, always. Enjoy. hg

Chapter 1

An introduction to taxation

Key Concepts

- Only individuals, C corporations, and fiduciaries pay income taxes.
- Corporations are taxed on taxable income, which is the difference between gross income and deductions. The nominal tax rates for corporations vary from 15 to 35 percent.
- In determining taxable income, individuals are allowed two sets of deductions from gross income – deductions *for* adjusted gross income and deductions *from* adjusted gross income. They are also allowed to deduct personal dependency exemptions. Individual tax rates vary from 10 to 35 percent.
- Sole proprietorships, partnerships, and S corporations are all business entities whose income and losses are passed through to owners and included in owners' tax returns for payment of income taxes.
- Other taxes levied by governmental units include sales or use taxes, wealth or property taxes, and wealth transfer taxes.

1. An introduction to taxation

a. What is a tax? You must pay them, but they might not benefit you.

b. History of income taxation in the United States

1913 16th amendment gave Congress the power to tax income from whatever source derived.

1939 Internal Revenue Code

1954

1986

c. Let's list a few objectives of taxation

Raising revenue

Horizontal equity

Vertical equity

d. Current influences on the tax law

2. Taxing units and basic income tax models

Only individuals, C Corporations and fiduciaries (estates and trusts) pay federal income taxes.

A business may be organized as a sole proprietorship, a partnership, a limited liability partnership (LLP), a limited liability company (LLC), an S corporation or a C corporation.

The income of C corporations is subject to double taxation: once at the corporate level and again at the owner level when the income is distributed as dividends to the owners.

a. Tax formula for a C corporation

Corporate tax is covered in Actg 617, a Master of Accounting class. We will do a little bit of work with corporations, but not much as we do not have the time.

Tax formula for an individual

b. Gross income

Inclusions on Page 7 of your text

Exclusions on Page 8 of your text

Losses- business losses, investment losses, and personal losses

c. Property transactions

Amount realized

-Adjusted basis

Gain/Loss Realized

Whether or not this gain/loss is recognized depends on the tax law.

d. Deductions

The ordinary, necessary and reasonable expenses of carrying on a trade or business are deductible. Fines, bribes and expenses related to tax-exempt income are not deductible expenses.

Individuals have deductions for (above the line) and deductions from (below the line)
Page 10 of your text

Standard deduction (For 2004 is MFJ \$9,700 and for S \$4,850) or itemized
CANNOT TAKE THE STANDARD AND ITEMIZE IN THE SAME YEAR.

Personal and dependency exemption- for 2004 it is \$3,100

e. Determining the gross tax liability- pages 12 and 13

f. Tax losses

Net operating losses can be carried back 2 years or forward 20.

g. Additions to the tax liability
Alternative minimum tax

Self-employment taxes (social security and Medicare)

h. Tax prepayments and credits
Taxes withheld
Estimated tax payments
Tax credits on page 15

3. Choice of business entity

For tax return purposes, there are only four types of business entities:

Sole proprietorship income reported on Schedule C of individual 1040 due April 15

Partnership files an information return 1065 due April 15

C Corporation 1120 due March 15

S Corporation files an information return 1120S due March 15

a. Sole proprietorship (sole pro)

Simple

No employees or lots of employees

Owner is not considered an employee

Owner is considered self employed and must pay self employment tax

Owner is not eligible for tax-free employee fringe benefits

Tax return package would include Schedule C, SE, and 1040

Tax is based on net profits of the business, not cash flow

Schedule C loss can offset taxpayer's other income

A sole pro is not a separate entity from its owner

b. Partnerships (covered in Actg 617)

Consists of 2 or more individuals or entities that join together to carry on a business.

General partners have unlimited liability for ship debts.

Partners cannot be employees of their own ship.

Ship is a conduit.

Losses flow to owners

Taxed on income whether or not receive any cash.

Basis measures partner's investment in the ship.

c. Corporations (covered in Actg 617)

Limited liability

Stock represents ownership

Shareholder can be an employee and receive fringe benefits

Double tax- corporation pays income tax and shareholders pay income tax again on dividends. Dividends are not deductible by corporation.

d. S Corp (covered in Actg 617)

No more than 75 shareholders

Conduit

A more than 2% shareholder cannot participate in fringe benefits

Losses flow to owners

Chart on page 20 is very helpful.

4. Other types of taxes

Wealth

Wealth transfer

Consumption

Tariffs and duties

5. Types of tax rate systems

Progressive

Proportional

Regressive

6. Characteristics of a good tax

Equity

Economy

Certainty

Convenience