

# Objectives and Game Plan

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- ▶ Provide an overview of the class
- ▶ Provide some background on tax policy and the economics of taxation
- ▶ Outline the key points of “Scholes-Wolfson” framework



# What is 518?

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- ▶ MBA-Style Tax Strategy Course
- ▶ Blend of tax law, corporate finance, and microeconomics
- ▶ Birth-to-death approach with a focus on some high value-added applications (e.g., international, M&A)
- ▶ We will, however, also address some high-level issues to understand the economics of taxation and the underlying principles of the U.S. tax system
- ▶ We will address the taxation of individuals only to the extent they intersect with corporate topics or are useful to illustrate certain topics



# What is 518?

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- ▶ What we will cover
  - Corporate formation
  - Compensation
  - Investments and operations
  - Restructuring
  - Multijurisdictional tax planning



# Some big picture questions

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- ▶ Who levies taxes?
- ▶ Why do we tax?
- ▶ What do we tax?
- ▶ How do we tax?
- ▶ What are the effects of taxes?
- ▶ Who pays taxes?



# Tax avoidance vs. tax evasion

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## ► Tax Evasion

- The reduction of a person's tax liability through an activity that is either illegal, fraudulent, or is otherwise not in accordance with the tax law
- Tax evasion is a serious criminal offense
- Penalties (including prison terms) can be imposed on tax evaders
- We will not discuss tax evasion schemes in this course, other than to identify them as being illegal



# Tax avoidance vs. tax evasion

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## ► Tax avoidance

- The legal reduction of a person's tax liability. There is a general view that there exists no moral or ethical compulsion for anyone to pay more taxes than the law requires.
- Tax avoidance is not the same as cheating, though sometimes perceived as such.
- Uses what some people refer to as "loopholes" others call "incentives"
- To the extent you think our system of government allows rich and/or powerful citizens (with the ability to influence Congress) to obtain benefits, you might think that tax avoidance is somehow unethical or immoral. If so, you might still find this class useful, to help identify loopholes that ought to be closed.



# Overview of strategies

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- ▶ Hierarchy of responses
  - Timing
  - Financial
  - Real



# Shifting income

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- ▶ Over time (Defer, defer, defer!)
  - Delay recognition
- ▶ Between entities
  - Corporation to partnership or individual
- ▶ Between jurisdictions
  - Domestic to foreign
- ▶ Between types
  - Ordinary income into capital gains
  - Interest into dividends (or dividends into interest)
  - Active versus passive
  - US versus foreign source



# Limits on behavior - Anti-abuse doctrines

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- ▶ Substance over form / step transactions
  - Example: Sale of loss assets to an independent supplier with subsequent resale to a controlled subsidiary of the original owner
- ▶ Business purpose
  - Example: Splitting a corporation into two entities to take advantage of progressive rate structures.
- ▶ Arm's length/related party - Section 482
  - Example: If a company receives \$10 from a customer for product “A”, the company should receive \$10 for selling the same product to a related entity
- ▶ Assignment of income
  - Example: Income tax belongs to the “entity” that earns it
- ▶ Clearly reflect income - Section 446
  - Example: Prepaid expenses



# The “Scholes-Wolfson” Framework

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## General rules of effective tax planning

1. Consider all taxes  
explicit and implicit (lower before-tax return)
2. Consider all parties  
a multilateral approach (tax sharing)
3. Consider all costs  
tax and non-tax

*Goal is not to minimize taxes, but maximize after-tax return.*



# Tax clienteles

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- ▶ Certain taxpayers are more likely to own various kinds of assets or to organize production in particular ways
- ▶ Examples:
  - High tax bracket individuals are more likely to hold municipal bonds
  - Low tax bracket businesses are more likely to lease rather than buy equipment



# Tax arbitrage

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- ▶ Tax arbitrage involves the purchase of one asset (a “long” position) and the sale of another (a “short” position) to create a sure profit despite a zero level of net investment
- ▶ Arbitrage opportunities also exist when parties face different tax rates.
- ▶ Tax arbitrage can eliminate all taxes in a world without frictions (transaction costs) and restrictions (tax laws).

*Ask me about recent tax shelters cases.....*



# Some basic concepts

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- ▶ What is income?
- ▶ Haig-Simons definition of income (variously stated)
  - Consumption + net accretions to wealth
  - Money value of the net increase in the power to consume
  - Personal income + change in value of assets
    - NOTE: *all changes are measured as accrued, not realized and are independent of source or use*
  - Ability to pay principle
    - Capacity to pay a tax.
    - What do we base ability on? Income? Consumption? Wealth? Utility?



# Some basic concepts

## ► Equity

- Horizontal Equity - Equals should pay equal taxes
- Vertical equity - Unequals should pay unequal tax
  - *How do you measure “equal”*

## ► Progressivity

- Progressive
- Proportional
- Regressive

Tax Year 2000 Schedule X-Use if your filing status is Single				
If the amount on Form 1040, line 39, is: Over-	But not over-	Enter on Form 1040, line 40		of the amount over-
\$0	\$26,250	.....	15%	\$0
26,250	63,550	\$3,937.50 +	28%	26,250
63,550	132,600	14,381.50 +	31%	63,550
132,600	288,350	35,787.00 +	36%	132,600
288,350	.....	91,857.00 +	39.6%	288,350

Corporations also face progressive rates, however the benefit of the lower brackets are phased-out at higher levels, with the intent of achieving a flat rate of 35% for larger companies.



# Some basic concepts

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- ▶ Tax Incidence
  - Statutory versus Economic
    - The burden of the tax does not necessarily fall on the one who is taxed
  
- ▶ Equity v efficiency
  
- ▶ Excess Burden
  - Amount of loss (in welfare or utility) above and beyond the amount of tax collected
  
- ▶ How do these concepts apply to the corporation?



# Getting information on tax rules

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- ▶ Primary sources of federal tax rules
  - Internal Revenue Code
  - Committee reports (intent)
  - Treasury regulations (general interpretation)
  - Revenue rulings (clarification requests)
  - Private letter rulings (used in large transactions)
  - Judicial decisions
- ▶ Secondary sources
  - Commercial tax services
  - Commerce Clearing House (CCH) - Standard Federal Tax Reporter
  - Tax Notes & Tax Notes Today (Lexis)
  - Bureau of National Affairs (BNA) Tax Management Portfolios



# Getting information on tax rules

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- ▶ Practitioner tax journals
  - The Journal of Taxation / The Tax Adviser
  - The Journal of Corporate Taxation
  
- ▶ Academic journals devoted exclusively to tax issues
  - Tax Law Review (NYU Law School)
  - National Tax Journal
  - Journal of the American Taxation Association
  
- A recent review of research
  - Shackelford and Shevlin, “Empirical tax research in accounting,”
  - Maydew, “Empirical tax research in accounting: A discussion”
  - both in Journal of Accounting and Economics 31 (2001)*



## Some not-so random web sites

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<http://www.irs.ustreas.gov/prod/cover.html>

<http://www.ustreas.gov/taxpolicy/>

<http://www.house.gov/jct/>

<http://www.tax.org/>

<http://www.taxadmin.org/>

<http://www.brookings.org/dybdocroot/es/research/areas/tax/tax.htm>

<http://www.taxpolicycenter.org/>

<http://taxpolicyresearch.umich.edu/>

<http://www.taxfoundation.org/>

<http://www.opensecrets.org/>

<http://www.guidestar.org/index.jsp>

