

2 Chapter 2 -- Tax Planning Fundamentals: A taxpayer's liability is computed by first determining the taxpayer's taxable income and then by applying the appropriate tax rate structure to that taxable income. Congress can encourage or discourage specific activities by adjusting what goes into the tax base (that is, what gives rise to taxable income) or by adjusting specific tax rates. Congress has adopted both approaches, though in general it modifies the tax base more than it modifies the tax rate for specific tax items. The rules it enacts necessarily are both overbroad and under-broad. For example, a tax preference will on occasion fail to benefit all those who engage in the desirable activity and will on occasion benefit those who do not engage in the desirable activity. Because a taxpayer can choose its investments and the form that they take, it is the overbroad side of the equation that is most troublesome. To combat this problem, Congress tries to draft the preference very narrowly and then imposes anti-abuse rules to exclude overly aggressive taxpayers. The other institutional players in tax administration -- the Treasury Department (which includes the IRS) and the courts -- engage in similar activities by defining the rules properly and imposing their own anti-abuse rules. One issue that all players must consider is how much uncertainty in application of the tax rules is a desirable.

2.1 Types of Income Tax Planning: All else being equal, taxpayers seek to minimize their tax liability. They can do so in a variety of ways.

2.1.1 Converting Income from One Type to Another: Congress has long provided a tax preference *to individual taxpayers* (but not to corporate taxpayers) on long-term capital gain. Capital gain arises from the sale or exchange of an investment or business asset but not from sales of inventory, from periodic returns to capital such as interest and dividends (although dividends get a preference equal to the capital gains preference), or from labor. There are many kinds of tax-preferred income beyond capital gain.

2.1.1.1 The Capital Gain Preference and Carried Interests: Managers of private equity funds structure the fund as a partnership, with the investors contributing cash and the managers contributing services. The formation of the partnership is tax-free to all parties, and any gains eventually realized by the fund will be capital gain. The managers of the private equity fund thus obtain capital gain rather than ordinary income on the return to their contributed services. Quere: Is it accurate to describe the manager's profits as nothing more than a disguised form of compensation?

2.1.1.2 Suppose you are a taxpayer for whom owning a share of stock is disadvantageous, either for tax or non-tax regulatory reasons. How do you get the equivalent of stock ownership? Pay someone the current price of the stock in exchange for a contractual right to receive the future value of the stock (including dividends, if any). How will you find such a person? If your counterparty simply buys the actual stock, their contract with you is fully hedged; they have become your straw man. Note that the price you pay presumably will include some transaction fee to your counterparty as well as the assumption of a new credit risk

(that your counterparty will not pay). Could you avoid the upfront fee and pay the counterparty periodic interest (as if buying stock on margin)? One alternative is for you to purchase a bond for the same current cost as the stock, and then agree to swap your bond return (interest receipts plus value change, if any) for the stock return. This is called a “total return swap.” Note that two parties can agree to a total return swap without either party buying an asset.

2.1.1.3 Shifting Income from One Pocket to Another: If the two parties to a transaction are not treated equivalently, then a taxpayer sometimes can reduce taxes by taking both sides of the transaction. For example, a taxpayer who uses IRA funds to purchase an equity interest in the taxpayer’s business is able to obtain deferral on any gain resulting from success of the business. Note, though, that if the investment yields a loss, that loss cannot be deducted by the taxpayer but can only offset any gains recognized within the IRA, and use of such losses provides a tax benefit only when distributions are made from the IRA to the taxpayer.

2.1.2 Shifting Income From One Time Period to Another: Taxes deferred are taxes saved: that is, deferring a liability is equivalent to reducing the amount of the liability in present terms because the discounted burden of the liability is reduced. For example, deferring a \$100 tax liability for one year reduces the present burden of the liability to \$90.91, assuming a 10% discount rate.

2.1.2.1 There are two ways to postpone a tax liability: defer when income must be reported or accelerate when deductions can be claimed. Consider, for example, a taxpayer who has \$100 of income each year for two years as well as \$40 of deduction each year. Assume a flat 40% tax rate. On these numbers, the taxpayer has \$60 of taxable income each year, yielding an annual tax obligation of \$24. The present burden of the taxes thus equals $\$24.00 \text{ plus } \$24.00/1.06$, if we assume a 6% discount rate, and that that equals \$46.64 in present value terms. Suppose, however, that all of the deductions can be accelerated into the first year, resulting of taxable income of \$20.00 in year one and \$100.00 in year two. Now, the taxes will equal \$8.00 and \$40.00, and in present value terms that is $\$8.00 \text{ plus } \$40.00/1.06$, or \$45.73.

2.1.2.2 The realization principle provides that the mere appreciation in the value of an asset is not taxable; rather, the appreciation is taxable only when it is converted into some different form. For example, purchasing a share of stock for \$100 and then holding it while the stock appreciates to \$125 generates no tax liability, but selling the stock will produce a taxable gain of \$25.

2.1.2.3 Buying Young Whiskey: Suppose a taxpayer can purchase a certain quantity of young whiskey for \$1,000, and assume that whiskey

appreciates as it ages at a fixed rate of 10% per year. Such an investment is tax-preferred as compared with making an investment (such as in corporate bonds) that appreciates at the same rate but as to which the annual appreciation is taxable each year. Note that in a frictionless market with perfect access to the credit markets, a taxpayer could make an after-tax profit by borrowing at 10% to purchase the whiskey and deducting the annual interest cost each year (as well as by borrowing against the unrealized appreciation each year).

2.1.2.4 Special Dividends Declared and Paid in Late 2012: The tax rate on most dividends was increased, effective January 1, 2013. As a result, publicly traded corporations declared and paid special dividends in late 2012 and shifted dividends scheduled for January into the previous December.

2.2 Restrictions on Taxpayer Behavior

2.2.1 Economic Substance, Business Purpose, and Substance Over Form: The law is now well established that tax benefits will only be available if a transaction meets both the letter and the spirit of the statute. In particular, tax benefits arising from transactions that would not be undertaken absent the tax benefits likely will be denied. Congress recently codified the common law "economic substance" doctrine. Section 7701(o)(1) now provides: " In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." Tax benefits denied by reason of section 7701(o) incur an automatic 40% penalty if the transaction was not fully disclosed on the taxpayer's tax return and a 20% penalty if there was full disclosure.

2.2.1.1 Section 482 authorizes the government to recharacterize transactions in accordance with their true economic form when the transaction occurs between two or more commonly controlled entities.

2.2.1.2 Section 446(b) authorizes the Commissioner to adjust a taxpayer's method of accounting if the method used by the taxpayer does not clearly reflect the taxpayer's income.

2.2.1.3 Section 269 authorizes the government to deny tax benefits obtained by acquiring control of a corporation when the "principal purpose" for acquiring that control was "evasion or avoidance" of Federal income taxes.

2.2.2 Constructive-Receipt Doctrine:

2.2.2.1 Almost all corporate taxpayers use an accrual method of accounting under which income is recognized when all the events have occurred

- which establish the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy.
- 2.2.2.2 Individual taxpayers and some corporations use the cash receipts and disbursement method of accounting under which income is recognized when actually or constructive received. Constructive receipt occurs when the income is made available to the taxpayer or can be demanded without significant effort or cost.
 - 2.2.3 Related Party Versus Arm's-Length Contracts
 - 2.2.3.1 Transactions between related parties invariably draw extra scrutiny from the government and from the courts because there is no reason to trust the terms of the transaction.
 - 2.2.3.2 Note that parties engaging in multiple transactions are in a sense "related" to one another. For example, suppose a national grocery chain purchases a local grocery store, agreeing to pay \$500,000 for the assets of the local store and \$200,000 for a three-year agreement by the seller not to compete in the local area. It seems very likely that the total sale price of \$700,000 is fair for the assets plus the non-compete agreement, but do we have any confidence that the allocation of this amount between the assets and the agreement is accurate?
 - 2.2.3.3 Read the second and third paragraphs under "Related-Party versus Arms-Length Contracts on page 2-9. How might such a transaction be structured between unrelated parties so as to reduce the risk of post-contractual opportunism?
 - 2.2.4 Assignment of Income Doctrine: Because our tax rates are progressive (for noncorporate taxpayers), it is advantageous for a taxpayer to split the reporting of income among multiple taxpayers. In general, earned income is taxed to the earner and income from property is taxed to the owner of the property. Sales of income generally present no tax avoidance opportunity because the sale is itself taxable.
- 2.3 The Legislative Process and Sources of Tax Information
 - 2.3.1 Primary and Secondary Authorities
 - 2.3.2 The Legislative Process
 - 2.3.3 Regulations and Revenue Rulings that Result from the Passage of a Tax Act
 - 2.3.4 International Rules Applicable to U.S. Companies
 - 2.3.5 The Role of Judicial Decisions
 - 2.3.6 Secondary Authorities
 - 2.4 Appendix 2.2: More Detailed Examples of Tax Planning
 - 2.4.1 Example A2.1: Reclassifying corporate income to obtain more favorable tax treatment.
 - 2.4.1.1 The Corporate Dividends-Received Deduction: Corporations that invest in equity of other corporations can exclude most of any dividends they receive from the subsidiary corporation; this ensures that income

earned in the corporate sector is subject to the federal income tax once and only once. Debt investments are not excluded but rather are deducted by the subsidiary (i.e., payor) corporation. Suppose a large US corporation wishes to make a debt investment in some corporation but also wants to exclude the periodic return. USCo makes an equity investment in Loss Co, and Loss Co. makes a debt investment in the target corporation. The target corporation takes an interest deduction for what it pays to Loss Co, and USCo gets a dividend-received deduction (the equivalent of an exclusion) for the dividends received from Loss Co. (This likely will not work without additional structuring because of section 382.) A similar technique could be done with a foreign corporation used in place of a loss corporation.

2.4.1.2 The Corporate Dividends-Received Deduction: Investor Co wishes to sell its equity investment in Active Co. That sale of shares will result in a substantial taxable gain to Investor Co (recall there is no tax preference for capital gains received by a corporate taxpayer). So Investor Co will remove most of the value of its shares as a dividend immediately prior to the sale. This will reduce the value of Active Co, and so the share sale will generate little or no profit, thereby converting taxable capital gain into excludible dividends.

2.4.2 Example A2.2: Shifting income from one pocket to another: Deductible Payments to a Captive REIT. A REIT is a special kind of corporation that must generate almost all of its income from real estate investments including direct ownership of real estate or indirectly through mortgages on real estate. REITs must pay dividends each year equal to at least 90% of their taxable income, and the REIT is entitled to a dividends-*paid* deduction. Accordingly, if a REIT pays out 100% of its taxable income, it will avoid taxation entirely. A traditional corporation can create a captive REIT (owned almost entirely by the traditional corporation), and it can rent its office or store location from the REIT. The REIT then pays the rent out as a dividend, eliminating all taxable income from the REIT. And because dividends received from a controlled subsidiary corporation are largely or entirely excludible from the parent's income, there is no income to the parent to offset its deduction for rent paid. Note that this no longer works for federal income tax purposes but still works for many state income taxes.

2.4.3 Example A2.3: Shifting income from one time period to another: The COLI Tax Shelter. The COLI tax shelter is essentially the same as the young whiskey investment: companies would purchase life insurance on the lives of their employees and enjoy *the free inside build-up* (equivalent to the appreciation in the whiskey). Note that the borrowing to purchase the policies is a red herring: the tax benefit arises from the free inside build-up whether the investment is funded with debt or equity.

- 2.4.4 Example A4: Shifting income from one time period to another: Shorting Against the Box. Consider a taxpayer who owns substantially appreciated stock. The taxpayer would like to monetize the value of the stock and eliminate risk that the stock will decline in value. The taxpayer borrows identical stock and sells the borrowed shares: no gain is recognized because the taxpayer is treated as purchasing the borrowed shares with debt equal to current fair market value. When the loan comes due, the taxpayer transfers the previously-purchased shares, recognizing gain equal to the value of the shares at the time of borrowing less the taxpayer's adjusted basis in the old shares. (This is called "shorting against the box" because selling shares you do not own is called "shorting" the stock and the "box" is shorthand for shares held and kept in a safe (or other box).) Note that Congress now treats this transaction as an immediate sale of the old shares under the constructive sale rule enacted in 1997.
- 2.4.5 Questions: (p. 2-15):
- 2.4.5.1 Question 1: The exclusion for interest received on state and local bonds is intended to reduce the borrowing costs of state and local governments, but some of the benefit may leak to the bond holders (that is, the implicit tax may be less than the explicit tax on a fully taxable state or local bond).
- 2.4.5.2 Question 2: Direct expenditures are one alternative. For example, instead of providing an exclusion for interest received on state and local bonds, the federal government could simply reimburse state and local governments for a portion of their borrowing costs. In addition, if Congress wishes to encourage specific activities, it could engage in those activities directly. For example, employer-provided health care is heavily subsidized through the Internal Revenue Code. The federal government could instead simply provide health care ("Medicare for All").
- 2.4.5.3 Question 3: Greater specificity in the law can only be achieved at the higher cost of drafting and legislating. Moreover, where it is expensive for the taxing authority to monitor taxpayers' affairs closely (in other words, in the real world) specific rules can provide greater opportunities for taxpayers to structure their affairs in a way that exploits the rules. Greater specificity in the rules would also impose greater burdens on taxpayers and the taxing authority in learning what the relevant rules are. Once learned, however, greater specificity in the rules would give rise to fewer disputes between taxpayers and the tax collectors regarding tax liabilities.
- 2.4.6 Exercises (p. 16-17):
- 2.4.6.1 Exercise 13:

- 2.4.6.1.1 Part (a): If the taxpayer receives the income immediately, he will owe \$32,000 in taxes, leaving \$68,000 to invest. Investing that sum at 10% for one year will give the taxpayer an additional \$6,800 of income, so the taxpayer will owe an additional \$2,176, leaving the taxpayer with \$68,000 + \$6,800 - \$2,176, or \$72,624. If the taxpayer defers receipt for one year, the taxpayer will have \$110,000 - \$35,200, or \$74,800. How can you explain the difference of \$2,176? The \$100,000 will grow by \$10,000 over one year. The majority of that growth will belong to the taxpayer. By deferring receipt, the taxpayer has the full \$100,000 to invest.
- 2.4.6.1.2 Part (b): If the income is received immediately, then the taxpayer's after-tax return at the end of year 2 will equal $\$100,000(1-t)(1+R(1-t))$, where t is the tax rate and R is the interest rate received on the proceeds. If receipt is delayed until the end of year 2, the return will be $\$110,000(1-t)$. Setting these two equal and then solving for R yields $R = 0.10/(1-t)$. With $t = 0.32$, we get $R = 14.71\%$.
- 2.4.6.1.3 Part (c): Take the money now. Immediate taxation now yields $\$100,000(1-0.32)(1+0.10(1-0.35)) = \$72,420$. Deferral yields $\$110,000(1-0.35) = \$71,500$.
- 2.4.6.1.4 Part (d): We equate the two alternatives and solve for t_2 :
 $\$100,000(1-0.32)(1+0.10(1-t_2)) = \$110,000(1-t_2)$, or
 $\$68,000(1+0.10(1-t_2)) = \$110,000(1-t_2)$, or $1+0.10(1-t_2) = [(\$110,000 / \$68,000)](1-t_2)$, or $1.10 - 0.10t_2 = 1.6176 - 1.6176t_2$, or $1.5176t_2 = 0.5176$, or $t_2 = 34.11\%$.
- 2.4.7 Exercise 14: The pre-tax rate of return is $(\$50,000 - \$100,000) / \$100,000$, or negative 50%. The after-tax rate of return is $(\$50,000 * (1-0.28) - \$100,000 * (1-0.70)) / \$100,000 * (1-0.70)$, or $(\$36,000 - \$30,000) / \$30,000$, or 20%.
- 2.4.8 Exercise 15:
- 2.4.8.1 Part (a): By paying herself a salary of \$50,000, the taxpayer reduces the corporation's taxable income from \$100,000 to \$50,000. But the taxpayer now has an additional \$50,000 of ordinary income, possibly taxed as high as 37%.
- 2.4.8.2 Part (b): By declaring \$50,000 of dividends, the corporation's taxable income remains unchanged because dividends paid are not deductible. In addition, the taxpayer now has \$50,000 of dividend income taxable at 20%.
- 2.4.9 Exercise 16:
- 2.4.9.1 Part 1: Company A, the high tax company reports zero income while company B reports income of \$1 million and pays very little tax because

of the use of the NOL. (The company can use NOLs up to 80% of taxable income so they would have \$200,000 of taxable income after using \$800,000 of the NOL.)

2.4.9.2 Part 2: The government likely will challenge the form of the transaction under section 482, arguing that A is undercharging B. For example, if the fair value of the goods sold wholesale is \$2.5 million, then A will earn \$500,000 and pay tax on that amount.

2.5 Problems (p. 33):

2.5.1 Problem 20: Taxpayer A has \$50,000 of ordinary income taxed at 37%. Taxpayer B has \$50,000 of capital gain, taxed at 20%. If taxpayer B lives in the house for at least 2 years, then the gain (up to \$250,000 of gain if single) is excluded.

2.5.2 Problem 21:

2.5.2.1 The loan to the corporation generates interest deductions for the corporation and assuming the new corporation generates sufficient income to use the deductions in full the interest deductions then generate an immediate tax benefit. However, the interest income is also taxable to the lender – the owner taxpayer in this case. If the corporation and the taxpayer face the same tax rates, then the net tax is zero. If the corporation faces a lower tax rate (as under current law) then there is a net tax payment to the tax authorities.

2.5.2.2 Dividends are not tax deductible to the corporation and are taxed to the recipient (currently at the lower, long-term capital gains rates). With the corporate rate being low it may not be such a tax disadvantage to pay dividends, but it would be unusual in a new company as normally the funds are needed inside the company for investment and other business operations. Any increase in value of the firm (more specifically, in the value of the equity) is deferred until the taxpayer sells the shares and then any gain is taxed at favorable capital gains rates.

2.5.2.3 Thus the taxpayer has to consider the tax rate of the corporation and herself when evaluating the amount of debt to put in the corporation. In addition, the taxpayer should consider how long corporate profits can be reinvested inside the corporation. If corporate profits are distributed annually, there will be a corporate level tax of \$21 per hundred of profit following by 20% on the distributed \$79 (i.e., a shareholder-level tax of \$19.8), for a total tax burden of \$40.8. That is higher than if the funds had been earned directly by the shareholder. Note that if the corporate earnings are not distributed immediately, the shareholder-level tax can be deferred and, if the stock is held by the taxpayer until death, the shareholder-level tax is eliminated.

2.5.3 Problem 22: Since the interest on the borrowed funds can only be deducted against other investment income taxed at ordinary rates, purchase of non-dividend paying stock generates no annual investment income and thus the

interest is not tax deductible. The interest is deductible against any gain arising from the later sale of the stock. Whether this is a good strategy depends on the annual appreciation in the stock price: if the stock appreciates at a higher rate than the interest rate on the borrowed funds, the taxpayer will make a pre- and post-tax profit.

2.5.4 Problem 23:

2.5.4.1 Part (a): Shortening the carryback period likely will result in more losses being carried forward, reducing the expected present value of the tax savings from the losses. Lengthening the carryforward reduces the probability that the increased losses now being carried forward would expire unused under the old 15 year carryforward period.

2.5.4.2 Part (b): In 1997, the firm can carry back losses three years. If there is no change in plans, the \$250,000 loss gives rise to a refund of \$87,500 ($\$250,000 * 0.35$) with expected taxes in 1998 of \$175,000 ($\$500,000 * 0.35$). If \$50,000 of income is deferred from 1997 to 1998, this increases the 1997 loss by \$50,000 to \$300,000, all of which can be carried back to obtain a refund of \$105,000 ($\$300,000 * 0.35$). Expected taxes in 1998 are \$192,500 ($\$550,000 * 0.35$). That is, the refund increases by \$17,500 ($\$50,000 * 0.35$) in 1997 but taxes increase by a similar amount in 1998. As a result, the firm gains the use of \$17,500 for one year which at an after-tax earnings rate of 6% can be invested to earn \$1,050.

2.5.4.3 Part (c): Carryback results in additional tax savings of $0.45 * \$50,000 = \$22,500$ (compared to \$17,500 in (b) when the tax rate in the carryback period was 35%). Assuming the tax rate in 1998 is 35%, the additional \$50,000 income in 1998 gives rise to an additional tax of \$17,500 (same as part b). Thus the tax savings here are an additional refund of \$5,000 without an incremental increase in future taxes. The \$5,000 can also be calculated as $\$50,000 * (0.45 - 0.35)$. Note also the \$5,000 can also be reinvested in 1997 to earn additional income. Thus when tax rates are expected to decline in the future and the firm has losses in the current period which can be carried back, it is tax advantageous to increase the magnitude of the losses by deferring income or accelerating deductions (ignoring any nontax costs associated with these strategies).

2.5.4.4 Part (d): The result is the essentially the same but stronger in 2017. Going forward there is no loss carryback and the corporate tax rate is much lower. Thus, the company should try to take as many deductions (including their losses) when the tax rate is 35% rather than when the tax rate is 21%. Reporting a larger loss in 2017 that can be carried back to offset income previously taxed at 35% and reporting more income in 2018 when the tax rate is 21% is the best solution.

2.5.4.5 Part (e): Carry forward a loss when the tax rate in the future is expected to be greater than the tax rate of the carryback period. Note also that carrying forward a loss delays the refund and thus the foregone earnings on the refund. It can be shown that a carryforward is optimal if $t_b(1+r)^s < t_f$, where t_b is the tax rate during the carryback period, t_f is the tax rate during the carryforward period when the loss is eventually deducted, r is the firm's after-tax earnings rate, and s is the number of periods before the loss will be used up in the carryforward period. To illustrate, suppose $t_b = 0.30$, $t_f = 0.40$, and $r = 0.05$. With a one-year carryforward ($s=1$), the left-hand side of the above equation equals 0.30×1.05 , or 0.315 which is less than 0.40. That is, if the firm carries back a dollar of losses, it obtains a refund of 30 cents which it can invest at 5% for one period accumulating to 31.5 cents at the end of the next period. If the loss is carried forward to obtain a refund next period the firm has 40 cents. Carryforward is preferred. If $s = 5$ years, then carryback with reinvestment of the refund accumulates to $0.30(1.05)^5$, or 38.3 cents, still less than the 40 cents from the refund. A carryforward period of 6 years equates the two alternatives. Waiting any longer than 6 years to use up the loss carryforward is not tax favored because immediate carryback and reinvestment accumulates to more than 40 cents.