Income Tax

Plan

- Tax unit: who is subject to tax
- Tax base: what is subject to tax
- Rate schedule: how the base is taxed

Tax Unit

- The 16th Amendment to the American Constitution gives the US Congress the right to impose an income tax (1913)
- Everyone residing permanently in the US must pay tax on income, regardless of where in the world the income originates.
- People who are neither citizens nor permanent residents have to pay tax on the income that originates in the US
From “The Truth about Frivolous Tax Arguments” (Tax info for you in www.irs.gov)

The Sixteenth Amendment provides that Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration. U.S. Const. amend. XVI.

Contention: Federal income taxes constitute a “taking” of property without due process of law, violating the Fifth Amendment. Some assert that the collection of federal income taxes constitutes a “taking” of property without due process of law, in violation of the Fifth Amendment. Thus, any attempt by the Internal Revenue Service to collect federal income taxes owed by a taxpayer is unconstitutional.

From “The Truth about Frivolous Tax Arguments”

- The Law: The Fifth Amendment to the United States Constitution provides that a person shall not be “deprived of life, liberty, or property, without due process of law ...” The U.S. Supreme Court stated in Brushaber v. Union Pacific R.R., 240 U.S. 1, 24 (1916), that “it is ... well settled that [the Fifth Amendment] is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict with itself by conferring upon the one hand a taxing power, and taking the same power away on the other by limitations of the due process clause.” Further, the Supreme Court has upheld the constitutionality of the summary administrative procedures contained in the Internal Revenue Code against due process challenges, on the basis that a post-collection remedy (e.g., a tax refund suit) exists and is sufficient to satisfy the requirements of constitutional due process. Phillips v. Commissioner, 283 U.S. 589, 595-97 (1931).

Tax Base

- Taxable income
  - Measured on the net basis
    - Does not include the expenses that incurred to acquire income
  - Is broadly defined
    - Earned income (employment compensation)
    - Capital income (receipts of interest, dividends, royalties, rental income, business profits and realized net capital gains);
    - Transfer income (gifts, bequests, benefits, etc.)
From “The Truth about Frivolous Tax Arguments”

Contention: Wages, tips, and other compensation received for personal services are not income.

This argument asserts that wages, tips, and other compensation received for personal services are not income, because there is allegedly no taxable gain when a person “exchanges” labor for money. Under this theory, wages are not taxable income because people have basis in their labor equal to the fair market value of the wages they receive; thus, there is no gain to be taxed.

The Law: For federal income tax purposes, “gross income” means all income from whatever source derived and includes compensation for services. I.R.C. § 61. Any income, from whatever source, is presumed to be income under section 61, unless the taxpayer can establish that it is specifically exempted or excluded. In Reese v. United States, 24 F.3d 228, 231 (Fed. Cir. 1994), the court stated, “an abiding principle of federal tax law is that, absent an enumerated exception, gross income means all income from whatever source derived.” All compensation for personal services, no matter what the form of payment, must be included in gross income. This includes salary or wages paid in cash, as well as the value of property and other economic benefits received because of services performed, or to be performed in the future. Furthermore, criminal and civil penalties have been imposed against individuals relying upon this frivolous argument.

Filing Status

Your income, filing status, and age generally determine whether you must file an income tax return. Generally, you must file a return for 2001 if your gross income from worldwide sources is at least the amount shown for your filing status in the following table:

<table>
<thead>
<tr>
<th>Filing Status Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$7,450</td>
</tr>
<tr>
<td>65 or older</td>
<td>$8,550</td>
</tr>
<tr>
<td>Head of household</td>
<td>$9,590</td>
</tr>
<tr>
<td>65 or older</td>
<td>$10,650</td>
</tr>
<tr>
<td>Qualifying widow(er)</td>
<td>$10,500</td>
</tr>
<tr>
<td>65 or older</td>
<td>$11,600</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>$13,400</td>
</tr>
<tr>
<td>Not living with spouse at end of year</td>
<td>$2,900</td>
</tr>
<tr>
<td>One spouse 65 or older</td>
<td>$14,300</td>
</tr>
<tr>
<td>Both spouses 65 or older</td>
<td>$15,200</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$2,900</td>
</tr>
</tbody>
</table>

If you are the dependent of another taxpayer, see the instructions for Form 1040 for more information on whether you must file a return.
Haig-Simons definition of income

- Income is the money value the net increase in an individual’s power to consume during a given period.
- In other words it is the maximal value of consumption that a person can enjoy during the tax year without decreasing their wealth.
- In practice the income tax base is selective, it is not levied on everything that might be consumed (e.g. unrealized capital gains)

Calculating Taxable Income

- Taxable income is
  - adjusted gross income (AGI) minus
  - Personal Exemptions minus
  - Max (standard deduction, itemized deductions)

Adjusted Gross Income

- AGI=
  - Gross receipts from taxable sources
    - Earned income
    - Capital income
    - Transfer income
  - Minus adjustments
    - Business expenses (e.g., moving expenses)
    - Contributions to retirement plans
    - Alimony paid
    - Interests payments on student loans
Deductions

- Itemized deductions:
  - Charity (up to 50% of AGI)
  - State and local tax
  - Interest on mortgage
  - Unreimbursed medical expenses
  - Childcare expenses
  - Casualty losses
- Standard deduction
  - Fixed amount (1996: $4,000 single, $6,700 married filing jointly)

Rate schedule

- Marginal tax rate varies with income
- Marginal tax is higher with higher income
- There are 5 tax brackets.
- In 2000 they were:
  - 15%
  - 28%
  - 31%
  - 36%
  - 39.6%

Tax liability

- To get tax liability
  - Apply rate schedule to the taxable income
  - Subtract Tax Credits
    - Child tax credit;
    - Some college expenses
Homework #5

- On June 7, 2001, Public Law 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted.
- What changes (in the tax base and rate structure) were made?