Chapter 3
Tax Planning Strategies and Related Limitations

INSTRUCTOR'S MANUAL

Learning Objectives

3-1. Identify the objectives of basic tax planning strategies.
3-2. Apply the timing strategy and describe its applications and limitations.
3-3. Apply the concept of present value to tax planning.
3-4. Apply the strategy of income shifting, provide examples, and describe its limitations.
3-5. Apply the conversion strategy, provide examples, and describe its limitations.
3-6. Describe basic judicial doctrines that limit tax planning strategies.
3-7. Contrast tax avoidance and tax evasion.

Teaching Suggestions

This chapter provides an overview of the basic tax planning strategies that represent the building blocks of tax planning. It is placed early in the text to emphasize the importance of tax planning and to allow the students to form an early foundation of the basic planning techniques. In later chapters, as you discuss specific technical content (e.g., investments, compensation, property transactions), students should be able to identify and apply the basic tax planning strategies that apply to each transaction.

This chapter can be covered in 1 to 1.5 class sessions. Most of the concepts in the chapter are relatively straightforward and thus, should not present students with tremendous difficulty. If students have not been exposed to the concept of present value, this discussion may require more time. If students are familiar with present value, a short review should suffice. This chapter should be of interest to students given the importance of tax planning and the related wealth impact that these strategies can have. Thus, students should have a natural interest in the chapter's material. Nonetheless, discussing real life examples of these strategies should peak students' interests even more (see, for example, the "Taxes in the Real World" boxes in the text).

The chapter lends itself to covering in-class examples of each strategy. Included in the text are several basic examples of the strategies with additional problems in the end of chapter material that may prove useful.

In addition to discussing the basic tax planning strategies, the chapter introduces several judicial doctrines that limit tax planning (and apply in numerous tax settings). These doctrines represent key components of the tax law and will also be discussed later in the text when applicable. When discussing these doctrines, it may be useful to provide specific examples of their application (e.g., example 3-6 in the text).

Finally, this chapter provides a brief discussion of tax avoidance and tax evasion. This discussion provides an opportunity to discuss the importance of ethics in the accounting profession and the negative consequences associated with tax evasion. This discussion also provides an opportunity for students to remember the discussion of tax practitioner professional standards and civil and criminal penalties in Chapter 2.

Assignment Matrix

			Learning Objectives							Text Feature		
		Difficulty	LO3-1	LO3-2	LO3-3	LO3-4	LO3-5	LO3-6	LO3-7	Research	Planning	Tax Forms
DQ3-1	10 min.	Medium	X									
DQ3-2	10 min.	Medium	X									
DQ3-3	10 min.	Medium	X									
DQ3-4	20 min.	Medium		X							X	
DQ3-5	20 min.	Medium		X							X	
DQ3-6	20 min.	Medium		X							X	
DQ3-7	20 min.	Medium		X							X	
DQ3-8	20 min.	Medium		X	X						X	
DQ3-9	20 min.	Medium		X				X			X	
DQ3-10	20 min.	Medium			X						X	
DQ3-11	20 min.	Medium			X						X	
DQ3-12	10 min.	Medium			X							
DQ3-13	10 min.	Medium				X					X	
DQ3-14	10 min.	Medium				X					X	
DQ3-15	10 min.	Medium				X					X	
DQ3-16	10 min.	Medium				X					X	
DQ3-17	25 min.	Hard				X					X	
DQ3-18	25 min.	Hard					X				X	
DQ3-19	25 min.	Hard					X				X	
DQ3-20	20 min.	Hard					X				X	
DQ3-21	20 min.	Hard					X	X				
DQ3-22	20 min.	Hard					X					
DQ3-23	20 min.	Hard					X				X	
DQ3-24	20 min.	Hard					X				X	
DQ3-25	20 min.	Hard					X				X	
DQ3-26	20 min.	Hard					X					
DQ3-27	20 min.	Hard						X				
DQ3-28	25 min.	Hard						X			X	
DQ3-29	25 min.	Hard						X			X	
DQ3-30	25 min.	Hard						X				
DQ3-31	25 min.	Hard						X				
DQ3-32	25 min.	Hard							X			
DQ3-33	25 min.	Hard							X			
DQ3-34	25 min.	Hard							X			
P3-35	20 min.	Medium		X	X							
P3-36	20 min.	Medium		X	X							
P3-37	20 min.	Medium		X	X							
P3-38	20 min.	Medium		X	X						X	

P3-39	20 min.	Medium		X	X						X	
P3-40	20 min.	Medium		X	X						X	
P3-41	20 min.	Medium		X	X						X	
P3-42	20 min.	Medium		X	X						X	
P3-43	20 min.	Medium		X	X						X	
P3-44	20 min.	Medium		X	X						X	
P3-45	20 min.	Medium		X	X						X	
P3-46	10 min.	Medium			X							
P3-47	10 min.	Medium			X						X	
P3-48	10 min.	Medium			X						X	
P3-49	10 min.	Medium			X						X	
P3-50	10 min.	Medium			X						X	
P3-51	25 min.	Hard				X					X	
P3-52	25 min.	Hard				X					X	
P3-53	25 min.	Hard				X					X	
P3-54	20 min.	Hard				X					X	
P3-55	25 min.	Hard				X		X				
P3-56	25 min.	Hard				X		X				
P3-57	20 min.	Hard					X				X	
P3-58	20 min.	Hard					X				X	
P3-59	20 min.	Hard					X				X	
P3-60	20 min.	Hard					X					
P3-61	20 min.	Hard					X					
P3-62	25 min.	Hard					X				X	
P3-63	25 min.	Hard					X				X	
P3-64	25 min.	Hard							X			
P3-65	25 min.	Hard							X			
P3-66	20 min.	Medium		X		X	X					
P3-67	25 min.	Hard							X			
P3-68	25 min.	Hard							X			

Lecture Notes

1) Basic Tax Planning Overview
   a) Effective tax planning
      i) Goal of tax planning: maximizing the taxpayer's after-tax wealth while achieving the taxpayer's nontax goals
      ii) Three parties to every transaction: taxpayer, other transacting party, and the government
      iii) Astute tax planning requires understanding the tax and nontax costs from the taxpayer's and other party's perspective
      iv) 3 basic tax planning strategies: timing, income shifting, and conversion
2) Timing Strategies
   a) Timing
      i) When income is taxed or expense is deducted affects the associated "real" tax costs or savings.

ii) The time that income is taxed or an expense is deducted affects the *present value* of the taxes paid on income or the tax savings on deductions.
iii) The tax costs of income and tax savings of deductions vary as *tax rates* change. The tax costs on income are higher when tax rates are higher and lower when tax rates are lower. Likewise, the tax savings on deductions are higher when tax rates are higher and lower when tax rates are lower.

b) Present value of money
   i) $1 today will be worth *more* than $1 in the future
   ii) The implication of the time value of money for tax planning is that the timing of a cash inflow or a cash outflow affects the present value of the income or expense
   iii) When considering cash inflows, higher present values are preferred; when considering cash outflows, lower present values are preferred
   iv) Future Value = Present Value × $(1 + r)^n$
   v) Present Value = Future Value ∕ $(1 + r)^n$
   vi) Exhibit 3-1 provides discount rates for a single payment received in *n* periods using various rates of return
   vii) Work through Example 3-2

c) The timing strategy when tax rates are constant
   i) Two basic tax-related timing strategies
   ii) Accelerating deductions: essentially accelerating a current cash inflow
   iii) Deferring income: essentially deferring a current cash outflow
   iv) Work through example 3-3

d) The timing strategy when tax rates change
   i) When tax rates are increasing, the taxpayer must calculate the optimal tax strategies for deductions and income. Why?
   ii) The taxpayer must calculate whether the benefit of accelerating deductions outweighs the disadvantage of recognizing deductions in a *lower* tax rate year.
   iii) The taxpayer must calculate whether the benefit of deferring income outweighs the disadvantage of recognizing income in a *higher* tax rate year.
   iv) When tax rates are decreasing, taxpayers should accelerate tax deductions into earlier years and defer taxable income to later years. Why?
   v) Accelerating deductions maximizes the present value of tax savings from deductions due to the acceleration of the deductions into *earlier* years with a *higher* tax rate year.
   vi) Deferring income minimizes the present value of taxes paid due to the deferral of the income to later years with a *lower* tax rate.
   vii) Work through example 3-5

e) Limitations to timing strategies
   i) (1) Tax deductions often cannot be accelerated without the actual cash outflow that generates the deduction. (2) Tax law generally requires taxpayers to continue their investment to defer income. (3) A deferral strategy may not be optimal if the taxpayer has severe cash flow needs, if continuing the investment would generate a low rate of return compared to other investments, if the current investment would subject the taxpayer to unnecessary risk, and so on. (4) Constructive receipt doctrine: taxpayer must recognize income when it is actually or constructively received.

3) Income-Shifting Strategies
   a) Income shifting exploits the differences in tax rates across taxpayers by shifting income from high-tax-rate taxpayers (or jurisdictions) to low-tax-rate taxpayers (or jurisdictions) or shifting deductions from low-tax-rate taxpayers (or jurisdictions) to high-tax-rate taxpayers (or jurisdictions)
   b) Transactions between family members

        i) Children generally have lower marginal tax rates and therefore parents may shift income to children so it will be taxed at the child's tax rate
        ii) Assignment of income, IRS scrutiny of related-party transactions, and the kiddie tax limit this strategy
    c) Transactions between owners and their businesses
        i) Incorporating a business and thus shifting income from an individual to the corporation may result in lower current taxation of the business income [See example 3-8]
        ii) Shifting income from a corporation to an owner through tax deductible expenses (e.g., compensation, interest, rent) allows the owners to avoid double taxation on corporate profits
        iii) IRS scrutiny of related-party transactions limit this strategy
    d) Transactions across jurisdictions
        i) Income earned in different jurisdictions—whether in the United States or abroad, and for state income tax purposes, income earned in different states—is often taxed very differently. With a proper understanding of the differences in tax laws across jurisdictions, taxpayers can use these differences to maximize their after-tax wealth.
        ii) IRS scrutiny of transfer pricing, implicit taxes, and negative publicity (e.g., for moving operations abroad) limit this strategy.
4) Conversion Strategies
    a) Tax rates can vary across different activities: ordinary income is taxed at ordinary rates, long-term capital gains are taxed at preferential rates, and some income is tax exempt
    b) The conversion strategy is based on the understanding that the tax law does not treat all types of income or deductions the same.
    c) To implement the conversion strategy, you must be aware of the underlying differences in tax treatment across various types of income, expenses, and activities and have some ability to alter the nature of the income or expense to receive the more advantageous tax treatment.
    d) Work through example 3-11
    e) When the investment period is longer than one year, taxpayers can receive benefits from combining the timing strategy and the conversion strategy.
    f) Work through example 3-12
    g) Limitations of conversion strategies
        i) The Code itself also contains provisions to prevent a taxpayer from changing the nature of expenses and income
        ii) Implicit taxes may also reduce or eliminate the advantages of conversion strategies
5) Additional Limitations to Tax Planning Strategies: Judicial Doctrines
    a) The IRS also has several other doctrines at its disposal for situations where it expects taxpayer abuse. These doctrines apply across a wide variety of transactions and planning strategies (timing, income shifting, and conversion).
    b) Business purpose doctrine: IRS has the power to disallow business expenses for transactions that don't have a business purpose
    c) Step-transaction doctrine: IRS has the power to collapse a series of transactions into one to determine tax liability
    d) Substance-over-form doctrine: IRS can reclassify a transaction according to its substance (instead of its form)
    e) Economic substance doctrine: transactions must meet two criteria 1) the transaction must meaningfully change a taxpayer's economic position (excluding any federal income tax effects) and 2) the taxpayer must have a substantial purpose (other than tax avoidance) for engaging in the transaction.
6) Tax Avoidance and Tax Evasion
    a) Tax avoidance is the legal act of arranging one's transactions to minimize taxes paid.
    b) Tax evasion is the willful attempt to defraud the government by not paying taxes legally owed.
    c) Tax evasion falls outside the confines of legal tax avoidance.

From page 3-11

Ethics

Agnes Meher is the owner of LuPat, a profitable construction company that she operates as a sole proprietorship. As a sole proprietor, Agnes reports the business income from LuPat on her individual tax return. Agnes expects the business to generate $400,000 of taxable income this year, which in combination with her other income, will put her in the top tax bracket (39.6%). Agnes has two children named Ellie Mae and Spencer, ages 9 and 11 respectively, who do not currently have any taxable income. Agnes would like to shift some of her income from LuPat to Ellie Mae and Spencer to reduce the overall tax burden from the business income. To shift the income, Agnes hired Ellie Mae and Spencer to perform some janitorial and clerical services for LuPat, paying each child $20,000. What do you think of Agnes's strategy?

Discussion points:

- Agnes would like to reduce her overall tax burden.
- One way to accomplish this would be to shift income to her lower-taxed children.
- One issue to discuss is whether the salary paid to the children represents reasonable compensation for the services they provide. It may be questionable as to whether children of these ages can perform enough janitorial and clerical services to reach this standard.

Class Activities

1. Suggested class activities

- **Let's make a deal**: This chapter provides a great opportunity for students to research tax planning in the real world. As a game, you can assign students to locate via Internet research a discussion of a transaction in which tax planning played a major role (*á la* Disney-Marvel acquisition). Split the students into groups and have them add up the dollar value of the related transactions (one per group member) that they located in their research. The group with the aggregated largest value of transactions receives bonus participation points. As part of this game, the students should be required to print documentation regarding the transaction, describe the specific tax planning strategy, and classify it based on the tax strategies discussed in the text.
- **One versus the class**: Have one student volunteer as the "one" with the other class members being the "group." Use the "Key Facts" boxes in the text to develop basic multiple-choice questions (A, B, C answers) and then quiz the volunteer and the class on the questions. The volunteer and each class member will need to write the letters A, B, and C on separate sheets of paper and then hold up their appropriate response to the question. Once a student (either the "one" or a member of the "group") misses a question, her or she is eliminated from the competition. After 6 (or some other number) of questions, those students left standing receive bonus participation points for the day.

2. Research activities

- This chapter provides a good opportunity to get students to form the habit of identifying tax planning strategies using available resources (Internet, tax services, etc.). As an on-going class exercise, you can instruct the class that they will receive a certain specified number of points for every tax article (maximum of X points for the course) they submit that discusses a tax planning idea relating to the material covered in class. For every article submitted, students should classify the type of tax planning strategy (timing, income shifting, conversion) and be ready to provide a brief overview of the tax planning strategy to the class with a 3-5 minute presentation (for additional points, as deemed appropriate). This exercise is a great way to stress the importance and relevance of tax planning and to get students actively engaged in applying the material discussed in class. To the extent short class presentations are utilized, this exercise should also enhance students' presentation skills.