<u>Federal Income Tax 101</u>

This is just the basics. I don't want to write a summary of 500,000 pages of federal income tax law, and you certainly don't want to read it. The idea here is to give you an idea of how the system operates. Armed with a basic understanding of the law, tax planning ideas make more sense. Information that makes sense is more likely to be used in real life.

So, to begin: the purported purpose of the federal income tax law is to tax NET INCOME. What's net income?

Net income is "what you make" minus "what you spend making what you make". Congress, the IRS, the courts and guys like me kill lots of trees attempting to define all of the above. The result: The world's most complicated tax rules, some 500,000+ pages of mind-killing (Read: More boring than French movies), myopia-inducing (Read: "You'll go blind doing that"), vice-forming (Read: Will drive you to drink turpentine, or worse yet, gin) text.

The definition of "what you make" (a.k.a. – gross revenue or gross income): Anything that increases your wealth, unless the law says otherwise. Getting cash (e.g. – rents) increases your wealth. So does finding a brick of gold or a pocket watch in an old piano. So does trading services for services ("You fix my sink and I'll do your tax return"). Basically, anytime you receive, find or are given <u>anything</u> of value, you have income under the tax code. There are a fair number of exceptions under the law, including:

- <u>Loans</u>: If you receive a bona fide ("honest-to-goodness, totally for real, really!") loan, the loan proceeds are not taxable. A bona fide loan usually means money that must be paid back in a defined amount at a defined time, along with interest payments.
- <u>Gifts</u>: If you receive a gift or inheritance, it is not income and not taxable for income tax purposes. The person who gave you the gift (a.k.a. - "the grantor") may be on hook for a hefty gift tax (Uncle Sugar always has an angle).
- <u>Other Exclusions</u>: The Internal Revenue Code contains a number of items that would normally be considered part of gross income, but for Congress' decision to exclude these items from taxation – that's why they are called exclusions! For example, leasehold improvements to a landlord's property are not treated as taxable income. Without this exclusion, if someone came on to your property and turned bare rooms into offices, the value of the improvements would constitute gross income to you (because you "got something" or your "wealth increased"). Congress decided that if you lease your property and your tenant improves it (e.g. – adds a deck to that rental house), the value of the improvements is not taxable income to you. That is, the value of the improvements is excluded from income. Exclusions are sweet – good tax planners look for as many as possible for their clients.

Once we've figured out how much gross income we have, and have subtracted any excluded income, we then figure out our deductions. Normally, deductions arise from spending money on the business. Deductions reduce our gross income….that is, gross income minus all of our deductions equals taxable income (also known as "taxable income"). Not everything that you spend on for your business is deductible (That would be far too simple and force guys like me to get REAL jobs). For example:

- If you spend $1,000 on office supplies, the $1,000 is completely deductible against your gross income;
- If you spend $1,000 on business meals, only $500 is deductible against your gross income; and
- If you spend $1,000 on contributing to political campaigns that would lower (or at least simplify!) your business taxes, NONE of it is deductible. You can buy lots of office supplies for your business, or buy food & fun for your business, but you're not supposed to buy politicians. Go figure.

Just because our business spends money on a permissible activity does NOT mean that the expenditure is deductible. Many expenditures must be capitalized – that is, added to our books as an asset. Things that are capitalized (treated as assets) may produce some deductions (e.g. – depreciation) or no deductions at all. There are lots of very complicated rules (see a pattern here?) that determine whether assets produce deductions, and if so, how fast. Now you know why the law is ½ million pages! Some examples of capitalizing:

- You buy a computer. It must be capitalized – meaning that it goes on your balance sheet as an asset. Normally, you take a percentage of the purchase price of the computer as a deduction each year – this is called a depreciation deduction. For example, a business can normally deduct 20% of the cost of a computer in the year the computer is purchased, 32% in the second year, and so on. The exact amount deductible per year depends on the kind of asset purchased and the IRS' depreciation tables. In some cases, the computer may depreciated all in one year (I call it "super-depreciation", most tax people call it the "Section 179" deduction. Most tax people are really boring.)
- You buy a piece of raw land. It must be capitalized. Under IRS rules, raw land is not depreciable. You get no depreciation deductions. But at least the tenants can't rip out the carpets.

To summarize deductions: Many of your business' expenses are deductible, meaning that they reduce your taxable income. Anything that reduces your taxable income saves you money, because lower taxable income means lower taxes. Congress and their henchmen at the IRS created some very complex rules that determine whether, when and how fast an expense may be deducted. Most assets must be capitalized and deducted over time, if at all.

OK, we've looked at the definition of gross income, deductions and net income. Once we've defined something as net income, it gets taxed. How it gets taxed depends on the type of income involved. The type of income is very important, because certain types of income are taxed at much higher/lower rates than others. Most income is called ordinary income (makes sense, oddly enough). Such income is taxed at different rates, depending on how much you make (a.k.a. – "ordinary rates" or "your bracket"). For example, a married couple that files a joint return for the 2002 tax year would pay the following rates on ordinary income:

- $0 to $14,000 at 10%
- $14,001 to $56,800 at 15%
- $56,801 to $114,650 at 25%
- $114,651 to $174,700 at 28%
- 174,701 to $311,950 at 33%
- 311,950 or more at 35%

For example, if a married couple with a joint return had $24,000 of taxable income in 2003, they would owe $2,900 in federal income tax - $1,400 (10% on the first $14,000 in taxable income) plus $1,500 (15% on the next $10,000 in taxable, for total taxable income of $24,000). All income is treated as ordinary unless the law says otherwise.

An important "otherwise" is long-term capital gains. Any gains from the sale of capital assets (which are of course defined by a billion words in the law) that are held for more than a year (that's the "long-term" part of "long-term capital gains") are taxed at 15% (and sometimes less – there's ALWAYS an exception). Because long-term capital gains tax rates are lower than ordinary income tax rates, investors will define their income as capital instead of ordinary whenever legally possible.

One other important category of income is "earned income" (as distinguished from "unearned income"). Earned income (e.g. – wages, income from a "flipping business") is subject to social security taxes (a.k.a. self employment taxes) of approximately 15% (that's IN ADDITION to your income tax!). Unearned income (e.g. – rents, dividends, interest, long-term capital gains) is NOT subject to social security taxes. I take affront to the idea that rental income is not "earned" – but I won't whine too loudly since that classification makes rental income exempt from social security taxes! Whenever possible, investors will seek to define income as "unearned" to avoid social security taxes.

SUMMARY

The feds tax taxable income (Doyathink?). That's gross income ("anything of value that you get") less excluded income (defined by the law in painful detail) less deductions (also defined by the law in great, mind-numbing detail). Many expenditures are capitalized (treated as an asset) and normally produce deductions over time or not at all (meaning, that they do not immediately reduce your income). The amount of tax that you pay depends both on how much income you make AND what kind of income you make. Long-term capital gains and rental income get treated less badly ("better" in English, though not quite as accurate as "less badly") than other sorts of income. And Congress obviously hasn't dealt with tenants very much, because they classify rental income as "unearned". They've got a lot of room to talk about "unearned income"!

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