**Chapter 3**

**Tax Planning**

**Overview**

**Goal of Tax Planning**

**Three Things to Consider for Effective Tax Planning**

1. All Taxes

2. All Parties

3. All Costs

**Three Basic Tax Planning Strategies**

**1. Timing strategies** – deferring taxable income and accelerating tax deductions

The value gained from timing strategies is a function of the:

(1) time value of money

(2) MTR in current and future periods.

**1.1Timing Strategies When Tax Rate Changes**

Limitations on Timing Strategies

a. Non-tax costs

b. Constructive receipt doctrine

**2. Income shifting strategies** – shift income and deductions among taxpayers

The goal of income shifting strategies is to move income (deductions) from someone or someplace with a high (low) MTR to a low (high) MTR.

Limitations on Shifting Strategies

a. Assignment of income doctrine – income is taxed to the person that earns it

b. Arms-length transaction – all parties must negotiate for their own tax benefit

**3. Conversion strategies** – Classify income/expense to receive the most favorable tax treatment

**Examples of Tax Planning**

**1a.** Isabel, a calendar-year taxpayer, uses the cash method of accounting for her sole proprietorship. In late December she received a $20,000 bill from her accountant for consulting services related to her small business. Isabel has plenty of cash in the bank to cover the bill and can pay the $20,000 bill any time before January 5 of next year without penalty. Assume her marginal tax rate is 30 percent this year and next year, and that she can earn an after-tax rate of return of 12 percent on her investments. When should she pay the $20,000 bill—this year or next?

**b.** What if Isabel has a current MTR of 20 percent but expects a MTR of 40 percent next year?

**2.** Tesla is considering opening a plant in two neighboring states. One state has a corporate tax rate of 10 percent. If operated in this state, the plant is expected to generate $8,000,000 pretax profit. The other state has a corporate tax rate of 2 percent. If operated in this state, the plant is expected to generate $7,500,000 of pretax profit. Which state should Tesla choose?

**Summary of Judicial and IRC Limitations**

1. **Business Purpose Doctrine**
2. **Step Transaction Doctrine**
3. **Substance Over Form Doctrine**
4. **Economic Substance Doctrine (Codified)**