

## The Keys to the Universe Series

By Robert Ellis

### A Working Understanding of Tax Law

You probably think the tax code is way too large and way too complicated for you to understand. But that is simply not true. You can develop a working understanding of tax law in half an hour. That doesn't mean you will suddenly be an accomplished tax professional, but it does mean you will have the tools necessary to manage your income tax and identify legitimate deductions.

The two basics of tax law are which income is taxable and when, and which expenditures are deductible. If you don't know the basics you are flying blind. One thing is certain, if you don't understand tax law it is impossible to manage your income tax. One of our goals today is to simplify tax code and make it discernable to you. When we are through we will arrive at this conclusion.

Section 162 giveth, and the rest of the tax code taketh away. That is the conclusion we will eventually come to in this paper, but we aren't there yet.

In our experience, very few taxpayers have an effective working knowledge of tax law. Most tax professionals do have a working knowledge of the technical details of the code, but few of them have the knowledge I am going to give you today. In half an hour, you may very well know more about tax law than your tax professional does. Are you ready for that?

## Our Approach to Income Tax

The Ellis CPA Firm is the best firm in the world in their niche, which is, tax strategy for small business owners. That may be because they are the only firm in the world working in that niche, but you can expect certain competencies from the Ellis firm that you can't find at other firms.

This is the best time there has ever been to own a tax paying small business. It is generally not known, but the same constitutional amendment that instituted the income tax, also prevents the government from taxing anything except gains and ascension to wealth. In addition, for the past two decades Congress has been profusely producing tax preferences for small businesses. Those preferences have generally gone unused and unnoticed by most tax firms.

### TAX STRATEGY:

The Ellis firm and a few other sophisticated tax firms formulate tax strategies using that constitutional guarantee, tax preferences embedded in the tax code by the U.S. Congress, valid business purpose, structural preferences and a myriad of other favorable tax elections and options to keep income tax at legal minimums.

Although the other sophisticated firms provide a full range of service, the Ellis firm focuses its entire attention on tax strategy for small business owners. That is all we do. We are better at it.

## Let Me Ask Some Questions:

How many of you own a business or are building a business?

How many of you rely on your business income for your entire living?

How many of you intend to start a business?

How many of you rely on wage income to live on?

How many of you love your tax professional?

How many of you are comfortable that your income tax strategy takes advantage of every break legally available?

Is the way your tax return is prepared take advantage of every break legally available to you?

I have discovered 99% of small business owners pay too much income tax.

I have prepared tax returns for thousand of small business owners, and I have been monitoring their tax situation for more than thirty years. Actually I lied when I said 99%. I apologize. But if I told you what I actually found right off the bat, you would not believe me. I have actually discovered that every single one of the small businesses that came into our practice was paying too much income tax. 100%. That says terrible things about the state of my profession.

So, on to tax law.

## Constitution of the United States

The Constitution was signed in 1786. Within a decade the government was taxing people directly to pay for a dispute with France. The Civil War was financed with a direct tax. But in 1894 Congress tried to levy a direct 2% tax on income over \$4,000. In 1895 the Supreme Court held in Pollack vs. Farmer's Savings and Loan that direct tax was illegal. I believe that was a good case, and a good decision. In response, in the 16<sup>th</sup> amendment was passed and became a part of the constitution in 1913.

## 16th Amendment to the Constitution

"Congress shall have the right to lay and collect taxes from whatever source derived ..."  
Passed Congress in 1909.

In response to Polluck vs. Farmers Loan & Trust Co.

Ratification required by 36 states. Ratified by 42 states (requirement 36) in 1913.

New Mexico was the 36th state.

Four states rejected it.

Two never took it up.

As you can imagine, that wording was a difficult sell to voters. Voters were not going to vote for it. To entice people to vote for the amendment, Congress had to make major concessions in the legislative history surrounding the amendment. Those concessions promised they would only tax *"gains that accede to wealth."*

With that very important concession, the amendment was passed into law. The promises Congress added to legislative history became part of Constitutional law.

But immediately after the issue was ratified by New Mexico, controversy swelled around the 16<sup>th</sup> amendment. Groups alleged that the amendment had not been properly ratified, and others said the tax statutes were illegal. Still others, including the President of the United States claimed that "gains and ascension" clause were allowing the very rich to avoid income tax. He claimed they had the obligation to pay even more tax than the law required. He mercilessly persecuted the richest man in America, Andrew Mellon, during his entire administration.

## Historical Perspective

15<sup>th</sup> amendment (1870) gave the vote to African American men.

17<sup>th</sup> amendment (1913) provided for direct election of Senators.

19<sup>th</sup> amendment (1919) gave women the right to vote.

## Roosevelt vs. Mellon Controversy

During the 1930's Andrew Mellon, Secretary of Commerce under three Presidents and the man who gave us our finest art gallery, the National Gallery, was persecuted throughout the 1930's by President Franklin Roosevelt and his Secretary of Commerce, Henry Morgenthau. They claimed he did not pay enough income tax. The Treasury charged that Mellon had not paid enough taxes. Morgenthau told the prosecutor, *"I consider that Mr. Mellon is not on trial, but the privileged rich."* Mellon claimed he had the Constitutional right to arrange his affairs to avoid income tax. He was not exonerated until after his death. During the entire period he was on trial and being persecuted by the government, Mellon donated nearly one hundred million dollars to the National Gallery, including the entire cost of building and stocking it.

President Roosevelt conceded the error of this fiasco in 1941.

## Judge Learned Hand

Partly in response to Roosevelt's persecution of Mellon, Judge Learned Hand stated the following in a judicial decision. *"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible."* **U.S. Judge Learned Hand** - U. S. Court of Appeals, 1934.

## Glenshaw Glass ...

The uncertainty was cleared up in 1955 when the landmark Supreme Court case, Glenshaw Glass, was decided. This case determined that the income tax statutes were constitutional and that the 16<sup>th</sup> amendment was constitutional.

But we like the fact that this case embedded the concept of *"gains and accession to wealth"* in the Constitution when Glenshaw specifically said that *"gains"* were taxable because they were an *"undeniable accession to wealth."* It further defined *"gain"* as *"profit."* Those assurances stand between us and abusive income tax. That is immeasurable more important than holding tax unconstitutional because it wouldn't have lasted. The holding of *"gains and ascension to wealth"* will last as long as the 16<sup>th</sup> amendment lasts.

## Murphy

This very recent DC Court of Appeals case further strengthened that concept. In this case the court originally held that some court judgments resulted in nontaxable income. But the uproar from academics caused them first to vacate their decision, and then in June to reverse it. The eventual outcome will probably not be certain until the Supreme Court has its say.

What we like about the case is both sides used the "gains and profits" concept and the "accession to wealth" concept to support their particular position. So whatever the eventual decision, "gains, profits and accession to wealth" are more firmly embedded in the constitution.

## Internal Revenue Code

Sections 61 and 162 of the internal revenue code tell the whole story. Section 61 tells you what is taxable (everything including gains and profits). Section 162 tells you what is deductible as a business expense (everything ordinary and necessary). After those two codes, the rest of the tax code simply stirs the pot.

## Section 162

Then in 1954 Congress codified this concept into the Internal Revenue Code by adding section 162. "There shall be allowed as a deduction ALL the ORDINARY and NECESSARY expenses paid ... in carrying on any trade or business."

The key word there is **all**.

Determining ordinary and necessary is a matter of FACT, not law. It is up to you to determine what is ordinary and necessary, not the government. That may lead to controversy, but it is your decision. Section 162 giveth and the rest of the tax code taketh away. The rest of the tax code is devoted to chewing down everything we just covered.

## Facts

Every single week of my life I get a call from a client asking me what is deductible. Everyone struggles with that issue. But that is not wrong question and wrong person asking it. I should ask you what is deductible. Because it is up to you. Not me, not the government, not anyone else. When I was a kid I remember a cops and robbers show on TV named Dragnet. Sergeant Friday, the star of the show had a saying he was famous for. Whenever he was questioning a witness or a suspect, he always said, *“Just the facts Ma’am, Just the facts.”*

Tax law is not unlike criminal law. Facts determine everything. In a murder case, the big issue is not the law. Everyone knows murder is illegal. The big issue is, *“Did the guy do it.?”* That is FACT. The law is there in the background, but the facts determine the outcome.

It is the same thing with tax law. Facts are more important than the law. Facts determine what is deductible and what isn’t. Not me. Not the law. Not your neighbor. And, guess who determines what the facts are. You do. Not the IRS, not Congress, not your tax professional, you do. You determine what the facts are. That is the way it should be. I have an ongoing audit in which the IRS agent threw out three PDA’s the taxpayer purchased in his business. She said, *“These are personal.”* Just between you and me, how the hell would she know? That audit is headed to review. She overstepped her bounds.

## Dual Tax Systems

The way tax law has developed in the United States, dual tax systems have evolved, one for wage earners and one for business owners. It is far, far better to be a business owner than a wage earner. I am a very big fan of our dual tax system and our tax structure. It gets a lot of bad press, but it is a great system, and it is very favorable to business owners. And it is embedded in the CONSTITUTION. The government cannot change it without changing the constitution. So despite all the ranting and raving about the things they want to do, many of them are out of play until they change the constitution.

Too many tax systems and strategies are based on incorrect underlying assumptions about the tax law. So let’s start by examining the foundation upon which all tax law is built. The answer may startle you.

One of the things most people don’t understand, is that development of the American law from the 16<sup>th</sup> Amendment to the Constitution to Section 162 of the Internal Revenue Code created two tax systems, one for wage earners and one for business owners.

Business owners are guaranteed ALL their deductions by the Constitution of the United States. They are to be taxed only on the amount their wealth increases.

Wage earners are guaranteed absolutely no deductions. Not their dependents, not their mortgage, not anything. Everything hangs on the whim of Congress.

## Conclusion

A working understanding of tax law is one of the keys to the universe. It certainly is if income tax plays a major role in your universe. Rest assured, all business expenses are deductible and that is constitutionally guaranteed.

Section 162 giveth, and the rest of the tax code taketh away.

What will you do with this information?

