Preparing Your Taxes

Chapter 3

Learning Goals

LG1	Discuss the basic principles of income taxes and determine your filing status.
LG2	Describe the sources of gross income and adjustments to income, differentiate between standard and itemized deductions and exemptions, and calculate taxable income.
LG3	Prepare a basic tax return using the appropriate tax forms and rate schedules.
LG4	Explain who needs to pay estimated taxes, when to file or amend your return, and how to handle an audit.
LG5	Know where to get help with your taxes and how software can make tax return preparation easier.
LG6	Implement an effective tax planning strategy.

How Will This Affect Me?

There's an old joke that people who complain about taxes can be divided into two groups: men and women. This chapter helps you pursue the tax-planning goal of maximizing the money that you get to keep by legally minimizing the taxes you have to pay. Income, various adjustments to income, deductions, and credits are considered in computing taxes. The chapter walks through the steps in completing representative tax returns. The impact of Social Security taxes and tax shelters are considered. And a framework for choosing a professional tax preparer or tax preparation software is provided. After reading this chapter you should be able to prepare your own taxes or to better understand and evaluate how your taxes are prepared by software or a tax professional.

Financial Facts or Fantasies?

- Every individual or married couple is required to file a federal income tax return regardless of the amount of income earned.
- The amount of federal income tax withheld depends on both your level of earnings and the number of withholding allowances claimed.
- Federal income taxes are levied against the total amount of money earned.
- Gains on the sale of investments such as stocks, bonds, and real estate are taxed at the lower capital gains tax rate.
- Tax credits, deductions and exemptions reduce your taxable income by comparable amounts.
- An easy way to earn tax-deferred income is to invest in Series EE savings bonds.

Impact of Income Tax

- Typical American family pays more than one-third of its gross income in taxes including federal income tax, Social Security and Medicare tax, and state income, property, and sales tax.
- Goal is to legally minimize taxes
- About half of taxpayers pay no income tax, but all pay Social and Medicare Tax [total rate of 7.65% of wages is paid by employee]
- Taxpayers with income over $250,000 filed 2.4% of tax returns and paid 48.9% of the income tax

Tax Computation

- Tax = Tax Rate * Tax Base
- Name of tax indicates the tax base, e.g. property tax has value of property as the tax base; sales tax, tax base is sales, etc
- Lower tax by lowering tax rate or lower tax base
- Lower tax rate by nature of income – capital gains and dividends taxes at maximum of 20%, gain up to $250,000 single [$500,000 joint]from sale of personal residence is taxed at 0% rate.
- Lower tax base by deductions, exclusions, and exemptions

Tax Rates Single Taxpayer

Tax year 2014	
$0 - $9,075	10%
$9,076 - $36,900	15%
$36,901 - $89,350	25%
$89,3501- $186,350	28%
$186,351 - $405,100	33%
$405,101 - $406,750	35%
Over $406,750	39.6%

Tax Year 2015	
0 - $9,225	10%
$9,226 - $37,450	15%
$37,451 - $90,750	25%
$90,751 - $189,300	28%
$189,301 - $411,500	33%
$411,501 - $413,200	35%
Over $413,200	39.6%

Impact of Change in Rates

- Taxpayer with taxable income of $36,900
- For 2014 tax is (10% * $9,075) + (36,900 – 9,075)*15% = $5,081.25
- For 2015 tax is (10% * $9,225) + (36,900 – 9,225)*15% = $5,073.75
- A difference of $7.50 = 5% * (9,225 – 9,075)

Tax Rates

- The federal income tax is referred to as a progressive tax rate, as income increases, the tax rate also increases. So from above, the first $9,225 is taxed at 10%, the next $28,225 is taxed at 15%, and so on.

- Most sales taxes have a flat tax rate, e.g. 8%. However since the higher income taxpayer spends less of their income on items subject to the sales tax, the sales tax paid as a percent of income actually decreases as the income increases. Thus, the sales tax is referred to as a Regressive tax rate.

Tax Rates

- For planning purposes, tax rates are identified as
  - Average tax rate = Total tax / taxable income
  - Marginal tax rate = the tax on the last or next dollar of taxable income (the rate from the tax bracket that applies to the taxpayer)
  - The average tax rate is used for long range planning; the marginal tax rate, for short-term planning.

Tax Rates

- The filing status determines which tax rates a taxpayer uses. There are five filing statuses:
  - Single – Unmarried taxpayers
  - Married filing jointly – Taxpayers are married on the last day of the year and elect to file joint return.   When a joint return is filed, both taxpayers are liable for the tax. Most married couples file joint returns.
  - Married filing separate – Each spouse files their own return and they are only liable for their tax.
  - Head of Household – Single taxpayers who provide a household for a qualifying person (a dependent or a relative other than cousins)
  - Surviving Spouse – For two years after the death of a spouse, the surviving spouse may use the joint rates if they have a dependent child living with them

Take Home Pay

- Taxpayer's gross pay is reduced by income tax withholding, Social Security and Medicare taxes, and cost of benefits (such as health and life insurance, and retirement contributions) is called Take Home Pay.

Capital Gains, Capital Losses, and Dividends

- Capital Gains
  - Long-term – gain from sale of property held more than 12 months
  - Short-term – gain from sale of property held less than 12 months

  Short-term gains tax same as ordinary income, income other than capital gain income.

  Long-term gains have alternative reduced rates:

  0 % if tax bracket is 10% or 15%

  15% if tax bracket is 25%, 28%, 33%, or 35%

  20% if tax bracket is 39.6%

Capital Gains, Capital Losses, and Dividends

Dividends from domestic (US) corporations taxed at long-term capital gain rate.

Capital Losses in excess of capital gains are deductible up to $3,000 per year. Thus, if have a $50,000 capital loss, it will take 17 years to deduct.

Corporations can not deduct capital losses.

Three Types of Income
Type may limit deductions

- Active Income: Income from personal services and other noninvestment income
- Portfolio Income: Income from investments (gains, dividends, interest); amount will limit deduction for investment interest
- Passive income: Income from property not related to personal services of taxpayer. Loss from one passive investment may only be deductible against income from other passive investment; not deductible from active income.

Taxable Income

- Taxable income is computed as follows:
- Gross Income – all income from whatever source derived less amounts excluded by the Congress such as proceeds from life insurance, scholarships, gifts, interest on state and local bonds, and other.
- Subtract adjustments to income including business expenses, contributions to retirement funds, and other tax deductions.
- Yields Adjusted Gross Income [AGI]

Taxable Income

- Adjusted Gross Income
- Less Personal and dependent exemptions
- Less greater of standard or itemized deductions
- Taxable income, apply tax rates to get tentative tax
- Less tax credits plus additional taxes
- Total tax liability owed

Exemptions

- Exemptions reduce taxable income by $3,950 [$4,000 in 2015]
- Each taxpayer has personal exemption, thus two on joint return
- Also receive one exemption for each dependent
  - Qualifying Child – Must meet test for Relationship, Age, Residence, Support
  - Qualifying Relative -- Must meet test for Relationship, Support, Gross Income

Standard Deductions

You deduct greater of Standard Deduction or Itemized Deductions

Standard, amount depends upon filing status:

- Single $6,200 in 2014; $6,300 in 2015
- Joint, $12,400 in 2014; $12,600 in 2015
- Amount is adjusted each year for change in Consumer Price Index

Itemized Deductions

Itemized deductions include deductions for

- Medical Expenses if more than 10% of AGI
- State taxes but only Property and either income or sales tax
- Interest on mortgage up to two personal residences with total principal of $1,000,000; plus interest on Home Equity Loan up to principal of $100,000
- Charitable Contributions to a 501(c)(3) organization
  - Cannot deduction contributions to a person
  - Single contribution over $250, MUST have a letter from organization stating amount and that received no services
- Miscellaneous includes employee business expenses over 2% of AGI

Tax Credits

- Credits are dollar for dollar reduction in TAX: Value is amount of credit
- Deductions reduce Taxable Income: Value is deduction * tax rate
- Common credits:
  - Child tax Credit, $1,000 per dependent child
  - Education Credits
  - Residential Energy Credit
  - Child and Dependent Care Credit
  - Earned Income Credit

Pay as You Go

- Withholding Tax – Employer is required to withhold income tax from employee salary before paying the employee. Increases compliance.
- Banks and other financial institutions must withhold tax from amounts they pay to taxpayers.
- Self-employed or taxpayers having income that is not subject to withholding, must pay estimated tax on a quarterly basis.
- Tax Refund is tax owed less tax withheld + estimated tax paid.

Tax Forms

- Everyone can file Form 1040
- Other forms are 1040A and 1040EZ
- Using tax preparation software [Turbo Tax, Tax Act, others] reduces time and effort in filing. Significant time saving after two year learning curve

Tax Preparers

- Commercial tax return preparers, such as H&R Block
- CPAs
- Lawyers who specializes in tax
- Enrolled Agents
- All preparers must register with IRS
- “All taxpayers can do their own tax return as well as change the oil in their cars. But many prefer to pay someone to do both.”
- Preparers offer experience and knowledge

Tax Planning

- Income Shifting
  - Shift income to later years; deductions to current year
- Income Conversion
  - Convert ordinary income into capital gain
    - Preferred Stock v Bonds
    - Dividends v Interest
    - State or Local Bonds interest is exempt from tax

Tax Shelters

- An investment where part of the return is from tax savings, that it taxpayer pays less taxes because of the investment.
- Example is ownership of Real Estate Investments – Frequently real estate investments have loss that can reduce tax on other income, thus part of return is the tax saving from the loss.

Tax Audit

- IRS has responsibility to enforce tax laws
- Returns are selected for audit both because of high probability of error and on a random basis to judge level of compliance.
- If your return elected for audit,
  - Keep Calm
  - Gather records
  - If you made an error, learn from it