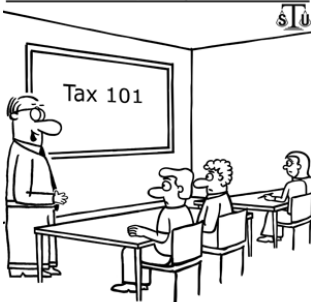


Fundamentals of Income Tax

Chapter 3

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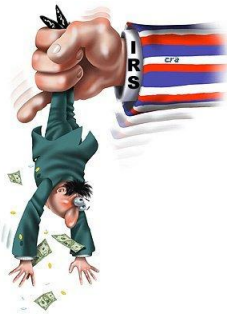
The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

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2

Tax Formula: Individuals

$$\begin{aligned} & \text{Income} \\ - & \text{Deductions} \\ \hline & = \text{Taxable Income} \\ \times & \text{Tax Rate} \\ \hline & = \text{Tax Liability} \end{aligned}$$



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Tax Formula Example

A single taxpayer with income of \$30,000 and deductions of \$10,000 has taxable income of \$20,000 ($\$30,000 - \$10,000 = \$20,000$). Using the 2012 tax rate schedule for the single filing status (see Appendix A in the textbook), the income tax liability is \$2,575.

For 2012, $((\$8,500 \times 10\%) + (\$11,500 \times 15\%)) = \$2,575$

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Federal Income Tax Formula

Income (broadly defined)

Less: Exclusions

Gross Income

Less: Deductions for AGI (*Above-the-line deductions*)

Adjusted Gross Income (*"The Line"*)

Less: Itemized or Standard Deduction (*Below-the-line deductions*)

Less: Personal and Dependency Exemptions

Taxable Income

Tax on Taxable Income

Less: Tax Credits

Tax Due (or Refund Due)



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Partial List of Exclusions

• Interest income from municipal bonds	• Cash or property received by gift
• Child support payments received from a former spouse	• Life insurance proceeds received because of the death of the insured
• Cash or property received by inheritance	• Gain on the sale of a principal residence
• Specified employee fringe benefits	• Scholarship or fellowship
• Qualifying distributions from a Roth IRA during retirement	• Deferral contributions to certain retirement plans

Exclusions are covered in detail in Chapters 4 & 5.

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Gross Income

- ▶ “All income from whatever source derived”
 - Money
 - Property
 - Barter
- ▶ UNLESS: the IRC contains a specific provision excluding a particular item from income

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Income Specifically Included Under I.R.C. § 61

- ▶ Compensation for services (including fringe benefits)
- ▶ Income derived from business
- ▶ Gains derived from dealings in property
- ▶ Interest and dividends
- ▶ Rents and royalties
- ▶ Alimony and separate maintenance payments
- ▶ Annuity payments
- ▶ Income from life insurance and endowment contracts
- ▶ Pensions
- ▶ Discharge of indebtedness
- ▶ Distributive share of partnership gross income
- ▶ Income in respect of a decedent
- ▶ Income from an interest in an estate or trust

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Hap Hazard by Bob Zahn
Hap Hazard

04-12-2007



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Federal Income Tax Formula

Income (broadly defined)

Less: Exclusions

Gross Income

Less: Deductions for AGI (*Above-the-line deductions*)

Adjusted Gross Income (*"The Line"*)

Less: Itemized or Standard Deduction (*Below-the-line deductions*)

Less: Personal and Dependency Exemptions

Taxable Income

Tax on Taxable Income

Less: Tax Credits

Tax Due (or Refund Due)



Deductions For AGI (*Above-the-Line*)

• Alimony paid	• Business expenses
• Contributions to IRAs	• Rental or royalty income expenses
• Tuition for higher education	• Losses from the sale of business property
• Interest paid on student loans	• Moving expenses

Adjusted Gross Income (*"The Line"*)

- ▶ Used to determine
 - Limitations on deductions
 - Limitations on credits
 - Phase-out of tax benefits

Deductions From AGI (*Below-the-Line*)

- ▶ Standard Deduction, or
- ▶ Sum of
 - Medical Expenses
 - Interest
 - Taxes
 - Casualty Losses
 - Charitable Deductions
 - Miscellaneous Itemized Deductions

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Standard Deduction

Filing Status	2011	2012
Married Filing Jointly	\$11,400	\$11,900
Married Filing Separately	\$5,800	\$5,950
Surviving Spouse	\$11,400	\$11,900
Head of Household	\$8,500	\$8,700
Single	\$5,800	\$5,950

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Additional Standard Deduction

- ▶ Allowed for taxpayer and spouse (not dependent)
 - Over age 65
 - Blind

Filing Status	2011	2012
Married Filing Jointly	\$1,150	\$1,150
Married Filing Separately	\$1,150	\$1,150
Surviving Spouse	\$1,150	\$1,150
Head of Household	\$1,450	\$1,450
Single	\$1,450	\$1,450

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Some Taxpayers MUST Itemize Deductions....

- ▶ A married individual filing separately cannot use the standard deduction if the spouse itemizes deductions.
- ▶ Nonresident aliens are not permitted to use the standard deduction.
- ▶ An individual who files a tax return for less than 12 months because of a change in the taxpayer's annual accounting period is not permitted to use the standard deduction.

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Partial List of Itemized Deductions

•Miscellaneous expenses that exceed 2% of AGI	•Medical and dental expenses in excess of 7.5% of AGI (for 2012)
•Charitable contributions	•State and local income taxes
•Tax return preparation fees	•Real property taxes on home
•Home mortgage interest	•Property taxes based on the value of a car
•Unreimbursed employee expenses	•Certain investment expenses
•Investment interest expense	•Casualty losses in excess of 10% of AGI

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The Personal Exemption

- ▶ This inflation-adjusted amount is allowed as a deduction for each personal and dependency exemption
 - \$3,650 for 2009
 - \$3,650 for 2010
 - \$3,700 for 2011
 - \$3,800 for 2012
- ▶ Disallowed above certain AGI levels after 2012

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Federal Income Tax Formula

Income (broadly defined)

Less: Exclusions

Gross Income

Less: Deductions for AGI (*Above-the-line deductions*)

Adjusted Gross Income (*"The Line"*)

Less: Itemized or Standard Deduction (*Below-the-line deductions*)

Less: Personal and Dependency Exemptions

Taxable Income

Tax on Taxable Income

Less: Tax Credits

Tax Due (or Refund Due)



Partial List of Tax Credits

- ▶ Foreign tax credit
- ▶ Credit for child and dependent care expenses
- ▶ Credit for the elderly or disabled
- ▶ Education credits (American Opportunity and Lifetime Learning)
- ▶ Retirement savings contribution credit
- ▶ Residential energy credits
- ▶ Child tax credit
- ▶ Earned income credit
- ▶ Additional child tax credit
- ▶ Business and investment credits

Anderson Case

		Item
Paul's Gross Salary	\$36,400	1
Paul's payment to his 401(k) retirement plan (withheld from his salary by his employer)	\$2,400	2
Stacey's Gross Salary	\$18,000	1
Stacey's cash gift from her mother	\$5,000	1, 2
Interest income from a joint savings account	\$100	1
Federal income taxes withheld from their paychecks	\$2,500	4
State income taxes withheld from their paychecks	\$1,680	
Charitable contributions (cash) paid to several charities	\$6,000	
Rent paid for apartment	\$10,000	
Contribution to a traditional IRA by Stacey	\$2,000	3

Filing Categories for Individuals

- ▶ Married Filing Jointly and Surviving Spouse
- ▶ Married Individuals Filing Separately
- ▶ Head of Household
- ▶ Single
 - Unmarried individuals (other than surviving spouses and Heads of Households)
- ▶ Estates and Trusts

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Requirements for Married Filing Status

- ▶ Married Filing Jointly
 - Married as of the last day of the taxable year
 - Spouse dies during the taxable year
- ▶ Surviving Spouse (Qualifying Widow)
 - Allowed for 2 years after death of spouse if taxpayer maintains a home in which a dependent child lives

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Married Filing Separately

- ▶ Often increases overall taxes
- ▶ Typically used when
 - Husband and wife are separated
 - One spouse suspects the other is not reporting income
 - Tax minimization purposes

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Requirement for Head of Household Status

- ▶ Unmarried as of end of year or an abandoned spouse
- ▶ Must pay more than $\frac{1}{2}$ the cost of maintaining a household for a dependent relative for more than $\frac{1}{2}$ the tax year
- ▶ Exceptions
 - Maintain a separate house for parents if at least one parent qualifies as a dependent

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Special Exception

- ▶ A married taxpayer may use a head of household filing status if the taxpayer:
 - is married,
 - files a separate tax return from the spouse,
 - maintains as his/her home a household which for more than one-half of the taxable year is the principal place of abode of a child who is a dependent,
 - furnishes over one-half of the cost of maintaining the household, and
 - the spouse is not a member of the household during the last six months of the year.

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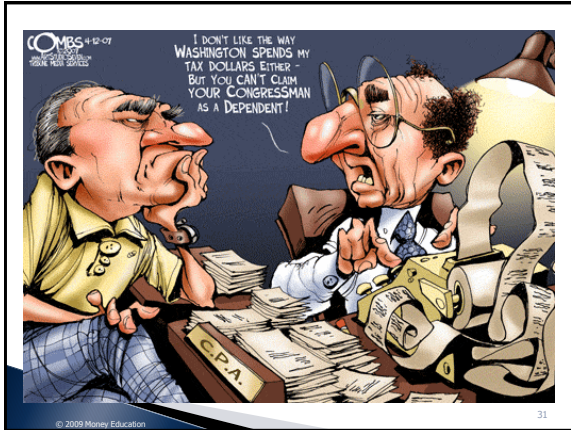
Personal & Dependency Exemptions

- ▶ Exemption Amount
 - 2012 - \$3,800
- ▶ Allowed for taxpayer, spouse, and dependents
- ▶ Subject to phase-out after 2012.
 - Lose 2% of exemption for each \$2500 over a threshold

Threshold Amounts	2009	2010-2012
Married Filing Jointly and Surviving Spouse	\$250,200	\$0
Head of Household	\$208,500	\$0
Single	\$166,800	\$0
Married Filing Separately	\$125,100	\$0

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Dependency Exemptions

- ▶ Taxpayers can claim a dependency exemption for each person who is considered a **qualifying child** or **qualifying relative**.
 - A qualifying child might not be the taxpayer's child at all
 - A qualifying relative in some cases is not a relative of the taxpayer
- ▶ All dependents must satisfy
 - The joint return test
 - The citizenship or residency test
 - Support test

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General Tests for Dependency Deductions

- ▶ **Joint Return Test**
 - A married dependent must not file a joint return with a spouse, unless
 - Return is filed to claim refund
 - Neither spouse is required to file a return
 - No tax liability exists for either spouse on separate returns
- ▶ **Citizenship/Residency Test**
 - Must be a citizen or national of The U.S., or
 - A resident of the U.S., Canada, or Mexico
- ▶ **Support Test**
 - The dependent cannot provide more than $\frac{1}{2}$ of his/her support for the year.

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Qualifying Child Tests

- ▶ In addition to the joint return and residency tests, a qualifying child must meet each of four tests:
 - A relationship test,
 - An abode test, and
 - An age test.

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Qualifying Child Tests

- ▶ **Relationship Test**
 - A qualifying child of a taxpayer may be:
 - The taxpayer's child,
 - A descendant of the taxpayer's child,
 - The taxpayer's brother, sister, stepbrother, stepsister, half brother, half sister, or
 - A descendant of the taxpayer's brother, sister, stepbrother, stepsister, half brother, or half sister.
- ▶ Once a relationship is established by marriage, it continues even if there is a change in marital status

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Qualifying Child Tests

- ▶ **Abode Test**
 - Child must live with the taxpayer for more than half the year
 - Temporary absences (i.e. away at college) do not count
- ▶ **Age Test**
 - Under age of 19 as of end of calendar year, or
 - Student under age of 24
 - Must be full-time student during 5 months of the year
- ▶ **Support Test for Qualifying Children – Special Rule**
 - If full-time student, scholarships are not considered

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Qualifying Relative

- ▶ In addition to the joint return and residency tests, a qualifying relative must meet all of the following tests:
 - Relationship test
 - Gross income test

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Qualifying Relative Tests

- ▶ **Relationship Test**
 - The taxpayer's child or a descendant of a child.
 - The taxpayer's brother, sister, stepbrother, or stepsister.
 - The taxpayer's parent or ancestor.
 - The taxpayer's stepmother or stepfather.
 - A child of the taxpayer's sibling.
 - A sibling of the taxpayer's parent.
 - A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer, or
 - Any other individual (who may be a totally unrelated person) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. A person who was married to the taxpayer during part of the year does not qualify.

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Qualifying Relative Tests

- ▶ **Gross Income Test**
 - Dependent's gross income < personal exemption amount

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Support Test: Multiple Support Agreements

- ▶ A group providing more than half support may claim a personal exemption even though no one taxpayer provides more than half of the dependent's support
 - Eligible parties must provide > 10% of support
 - Each eligible party must meet all other dependency requirements
 - Qualifying person must sign agreement not to claim the personal exemption for the year

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Support Test: Children of Divorced Parents

- ▶ For post-1984 divorce decrees, custodial parent gets exemption for children
 - Noncustodial parent may claim exemption for children if custodial parent signs a Release of Claim to Exemption



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Support Test: Children of Divorced Parents

- ▶ If child lives with both parents an equal amount of time, the parent with the higher AGI gets to claim the exemption

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Standard Deduction of a Dependent

- ▶ A taxpayer who is a dependent of another will have a limited standard deduction, equal to the greater of:
 - \$950 (2009, 2010, 2011 & 2012), or
 - \$300 plus earned income (but not exceeding normal standard deduction)

- ▶ If over age 65 or blind, can still use additional standard deduction amounts

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Standard Deduction of a Dependent Example 1

- ▶ Trevor is 17 years old and can be claimed as a dependent by his parents.
 - He earned \$3,000 in wages and \$400 in interest income during 2012.
 - His basic standard deduction is \$3,300 (\$3,000 of earned income + \$300).
 - His taxable income for 2012 is \$100

	2012
Wages	\$3,000
Interest Income	400
Less Personal Exemption	(0)
Less Standard Deduction	<u>(\$3,300)</u>
Taxable Income	<u>\$100</u>

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Standard Deduction of a Dependent Example 2

- ▶ Brandon is 17 years old and can be claimed as a dependent by his parents.
 - He earned \$7,000 in wages during 2012.
 - His basic standard deduction for 2012 is \$5,950 (the regular basic standard deduction for the single filing status:).
 - His taxable income for 2012 is \$1,050

	2009
Wages	\$7,000
Less Personal Exemption	(0)
Less Standard Deduction	<u>(\$5,950)</u>
Taxable Income	<u>\$1,050</u>

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Standard Deduction of a Dependent Example 3

- ▶ Martha is 72 years old and can be claimed as a dependent by her daughter.
 - She has \$3,000 of interest income during 2012.
 - Her basic standard deduction for 2012 is \$950.
 - Her total standard deduction is \$2,400 (\$950 basic standard deduction + \$1,450 additional standard deduction for age for 2012).
 - Her taxable income is \$600 for 2012.

	<u>2012</u>
Interest Income	\$3,000
Less Personal Exemption	(0)
Less Basic Standard Deduction	(\$950)
Less Additional Standard Deduction	(\$1,450)
Taxable Income	\$600

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The Kiddie Tax

- ▶ *Net unearned income* of a child under age 19 with a living parent (up to age 24 if full time student and claimed as a dependant) is taxed at the parent's marginal rate (or AMT rate, if applicable)
- ▶ *Net unearned income* does not include
 - standard deduction of \$950 (2012) for unearned income
 - the next \$950 (2012) of income which is taxed at the child's marginal rate

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Kiddie Tax Unearned Income

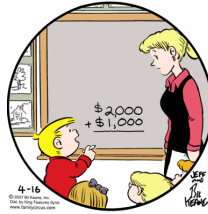
- ▶ Interest
- ▶ Dividends
- ▶ Capital gains
- ▶ Royalties
- ▶ Rents
- ▶ Pension and annuity income
- ▶ Unearned income from trusts

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Avoiding the Kiddie Tax

- ▶ Invest in savings bonds
- ▶ Invest in growth securities



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Kiddie Tax Example Earned and Unearned Income

Tate is 17 years old. He earned wages of \$4,000 and interest income of \$3,000 during 2012. He had no expenses related to producing the interest income. He is claimed as a dependent by his parents. Tate's net unearned income is \$1,100 (\$3,000 of interest income - \$950 - \$950). His taxable income for 2012 is \$2,700. His standard deduction is earned income plus \$300 or \$4,300.

	2012
Wages	\$4,000
Interest Income	<u>3,000</u>
Total Income	\$7,000
Less: Personal Exemption	(0)
Less: Standard Deduction (earned income + \$300)	<u>(4,300)</u>
Taxable Income	\$2,700
Taxed at Parent's Rate	\$1,100
Taxed at Child's Rate	\$1,600

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Kiddie Tax Example Unearned Income

Marcia is 16 years old and can be claimed as a dependent by her parents. She has unearned income of \$5,000. For 2012, \$3,100 of Marcia's unearned income is taxed at her parent's marginal rate.

	2012
Unearned Income	\$5,000
Less: Personal Exemption	(0)
Less: Standard Deduction	950
Less:	<u>*\$950</u>
Total	**\$3,100

*\$950 of unearned income is taxable to Marcia at her marginal tax rate.
 **\$3,100 of unearned income is taxable to Marcia at her parent's highest marginal tax rate.

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Return Filing Requirements

- ▶ **Must file if Gross Income > Standard Deduction + Personal Exemption**
 - The additional deduction for blind taxpayers does not apply to this determination
- ▶ **Return Filing Dates**
 - Calendar year taxpayers file on or before April 15 of following year
 - Noncorporate fiscal year taxpayers file on or before the 15th day of the fourth month following the close of the fiscal year
 - Corporate taxpayers must file on or before the 15th day of the third month following the close of the calendar or fiscal year
- ▶ **Applications for extension must be filed by the due date for the return**
 - An automatic 6 month extension is available



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When to File a Tax Return Example 1

- ▶ Enrique and Maria are married and normally file a joint return. Enrique is 66 years old and Maria is 64. They must file a return if their gross income is \$20,650 or more in 2012.

	2012
Personal exemption	\$7,600
Basic standard deduction	\$11,900
Enrique's additional standard deduction for his age	<u>\$1,150</u>
	\$20,650

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When to File a Tax Return Example 2

- ▶ Harold is unmarried, age 68, and blind. He must file a return if his adjusted gross income is \$11,150 or more for 2012).

	2012
Personal exemption	\$3,800
Basic standard deduction	\$5,950
Harold's additional standard deduction for his age	<u>\$1,450</u>
Age only (blindness does not count in this calc.)	\$11,150

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FICA

- ▶ Federal Insurance Contribution Act
 - Provides for old age, survivors, disability and hospital insurance
 - Social Security wage base limit is \$110,100 (for 2012)
 - 12.4% total (6.2% to employee and 6.2% match by employer) after March (4.2% for employee in Jan-Feb)
 - Medicare tax not subject to wage base limit
 - 2.9% total (1.45% to employee and 1.45% match by employer)

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FUTA

- ▶ Federal Unemployment Tax Act
 - Paid by employer only
 - 6.8% on first \$7,000 of employee's wages

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Self-Employment Tax

- ▶ FICA tax of 15.3% on earnings up to the wage base of \$110,100 (beginning March 2012)
 - 13.3% for Jan-Feb
- ▶ 2.9% beyond the wage base for Medicare tax
- ▶ Self-employed worker not required to pay FUTA on himself but is required to pay FICA

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Basic Tax Planning Principles

1. Receive income in a tax-exempt (excludible) form
2. Shift income to related taxpayers in lower marginal tax brackets
3. Generate income that is taxed at favorable capital gains tax rates
4. Defer income taxes until later
5. Use tax credits to reduce tax liability
