

Chapter 4. Taxes

Chapter Focus

- Taxes represent the largest source of revenue for both federal and state governments. Taxes are very complicated and we will only cover the basics in this chapter. We will focus on federal income tax, but will also cover Utah state income tax and estate tax to some degree. In addition, tax philosophies and different types of tax structure are discussed. Note that the textbook has more details than the lecture notes.

Major Topics

- Taxation philosophies
- Types of taxes
 - Earnings, purchases, property, wealth
- Federal income tax
- Utah state income tax
- Social Security tax
- Death and transfer tax
- Tax planning issues

Taxation Philosophies

- Benefits received philosophy
 - Those who receives the benefits of a particular public service should pay for it
 - Examples
 - Highway toll
 - Gasoline tax paying for highways

■ Ability to pay philosophy

- Progressive
 - The higher the income, the higher of a percentage paid
- Flat
 - Tax is a fixed percentage of one's income, no matter how high of an income one has
- Regressive
 - The higher the income, the lower of a percentage paid

■ Examples: John (\$20,000), Jane (\$100,000)

- Progressive
 - John pays 15% -> \$3,000 tax
 - Jane pays 28% -> \$28,000 tax
- Flat
 - John pays 20% -> \$4,000 tax
 - Jane pays 20% -> \$20,000 tax
- Regressive
 - John pays 28% -> \$5,600 tax
 - Jane pays 15% -> \$15,000 tax

Average vs. Marginal Tax Rates

- Marginal tax rate is the rate at which your last dollar is taxed.
 - Federal marginal tax rates in from 2003-2007
 - 10%, 15%, 25%, 28%, 33%, 35%
 - Historically these rates change.
 - 1992: 15%, 28%, 31%
 - 1993-2000: 15%, 28%, 31%, 36%, 39.6%
 - 2001: 15%, 27.5%, 30.5%, 35.5%, 39.1%
 - 2002: 10%, 15%, 27%, 30%, 35%, 38.6%
- Average tax rate is the overall percentage of total taxable income a household pays in tax

- Example: John and Jane: Married filing jointly with a taxable income of \$75,000
 - Tax liability in 2006
 - $(15100 \times 10\%) + [(61300 - 15100) \times 15\%] + [(75000 - 61300) \times 25\%]$
 $= (15100 \times 10\%) + (46200 \times 15\%) + (13700 \times 25\%)$
 $= 1510 + 6930 + 3425$
 $= \$11,865$
 - Marginal tax rate:
 - 25%
 - Average tax rate:
 - $11865/75000 = 15.82\%$

Types of Taxes

- Taxes on earnings
 - Federal income taxes
 - State income taxes
 - Social Security taxes
- Taxes on purchases
 - Sales tax
- Taxes on properties
 - Real estate property tax
 - Automobile property tax
- Taxes on wealth transfer
 - Estate tax
 - Inheritance tax
 - Gift tax

Federal Income Tax

- Take a look at [Form 1040](#), the most commonly used form
- Five types of filing status
 - Single
 - Married filing jointly
 - Married filing separately
 - Head of household
 - Qualifying widow(er) with dependent child

Figuring Out Taxable Income

- Gross income
 - Wages and salaries, alimony, interest, capital gains, dividends, pensions, business income, rentals, etc.
- Adjusted income (AGI) = Gross income plus or minus certain adjustments
 - Examples of possible exclusions: IRA (individual retirement savings arrangements) contributions, moving expenses, alimony paid

- Taxable income = Adjusted gross income - Exemptions - Deductions
 - Exemptions (\$3,300 for each exemption for 2006)
 - Deductions (either standard or itemized, whichever is higher)
 - Standard deductions in 2006
 - Single or Married filing separately: \$5,150; Head of household: \$7,550; Married jointly or qualifying widow(er): \$10,300
 - Typical itemized deductions:
 - Medical expenses in excess of 7.5% of adjusted gross income
 - State and local income taxes
 - Personal property taxes
 - Interest on home mortgages (limitations)
 - Charitable contributions (limitations)

Determining Tax Liability before Tax Credit

- Use the tax table or the tax schedule to figure out tax liability before tax credit.
- Tables calculate the numbers for you. Schedules give you the formula. They are consistent with each other.
- Which table to use depends on your filing status.
- Income ranges given in the schedules are called “income brackets”.
- There are four tax rate schedules. Two are shown on the next two slides.

Single Tax Rate Schedule for 2006

Schedule X—If your filing status is Single

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$7,550	..... 10%	\$0
7,550	30,650	\$755.00 + 15%	7,550
30,650	74,200	4,220.00 + 25%	30,650
74,200	154,800	15,107.50 + 28%	74,200
154,800	336,550	37,675.50 + 33%	154,800
336,550	.....	97,653.00 + 35%	336,550

Tax Rate Schedule for Married Jointly and Qualifying Widow(er)

Schedule Y-1—If your filing status is Married filing jointly or Qualifying widow(er)

If your taxable income is:		The tax is:	
Over—	But not over—		of the amount over—
\$0	\$15,100	..... 10%	\$0
15,100	61,300	\$1,510.00 + 15%	15,100
61,300	123,700	8,440.00 + 25%	61,300
123,700	188,450	24,040.00 + 28%	123,700
188,450	336,550	42,170.00 + 33%	188,450
336,550	.....	91,043.00 + 35%	336,550

An Example

- Your taxable income is \$35,000. Your filing status is single. How much is your tax liability?
- Answer:
 - Step 1. Use the table for single filing status.
 - Step 2. Your taxable income is between \$30,650 and \$74,200, so the formula applicable is $\$4,220 + [25\% * (35,000 - 30,650)] = \$4,220 + 1087.5 = \$5,307.5$
- Your marginal tax rate is 25%

Tax Credits

- Final tax = Tax liability minus tax credit
 - Tax credit is a dollar-to-dollar offset against tax liability
- Examples of possible tax credit
 - Earned income credit: Credit for low-income working individuals and families.
 - Child tax credit: \$1,000 (2006) per child

Payment or Refund?

- Withholding: Your employer is required to withhold some of your earnings for the IRS. Your annual earnings and tax withholdings are reported on a form called W-2.
- Employees decide on how many exemptions to claim on a W-4 form. The more exemptions you claim, the less tax withholding.
- If your total final tax is more than your tax withholding, then you need to send a check to IRS.
- If your total final tax is less than your tax withholding, then you get a refund.

Other Federal Income Tax Issues

- If one cannot pay
 - Form 9465: Installment agreement
- If one cannot file on time by April 15
 - Form 4868: Application for automatic extension of time
- Tax audition
 - keep your records for at least 3 years, possibly 6 years

State and Local Taxes

- All states levy taxes. But the tax structures vary quite a bit.
 - For most states, income tax is levied.
 - Sales tax and property tax are the two other common forms of state and local taxes.
 - For more information about your state taxes, visit your state tax website.

Utah State Income Tax – TC40

- Utah total adjusted income = federal adjusted gross income + some adjustments
- Taxable income = Utah total adjusted income minus deductions such as
 - Standard or itemized deductions (same as federal income tax amount)
 - Personal exemptions (\$2,325 per exemption in 2004)
 - 1/2 of federal tax

Tax Rate Schedule for 2006

<http://tax.utah.gov/forms/current/tc-40inst.pdf>

WORKSHEET A - For Single or Married Filing Separate

Use this worksheet if you entered code *A* or *D* on line 1 on the front of the return.

If taxable income from line 15 is →	\$0 to \$1,000	\$1,001 to \$2,000	\$2,001 to \$3,000	\$3,001 to \$4,000	\$4,001 to \$5,500	Over \$5,500
a. Taxable income from line 15						
b. Amount to subtract	0	\$1,000	\$2,000	\$3,000	\$4,000	\$5,500
c. Subtotal (subtract b from a)	=	=	=	=	=	=
d. Tax rate	X .023	X .033	X .042	X .052	X .06	X .0698
e. Subtotal (multiply c by d)	=	=	=	=	=	=
f. Amount to add	0	\$23	\$56	\$98	\$150	\$240
g. This is your Utah income tax. (Add lines e and f). Enter on line 17	=	=	=	=	=	=

Tax Rate Schedule for 2006

WORKSHEET B - For Married Filing Joint, Head of Household, or Qualifying Widow(er)

Use this worksheet if you entered code *B*, *C* or *E* on line 1 on the front of the return.

If taxable income from line 15 is →	\$0 to \$2,000	\$2,001 to \$4,000	\$4,001 to \$6,000	\$6,001 to \$8,000	\$8,001 to \$11,000	Over \$11,000
a. Taxable income from line 15						
b. Amount to subtract	0	\$2,000	\$4,000	\$6,000	\$8,000	\$11,000
c. Subtotal (subtract b from a)	=	=	=	=	=	=
d. Tax rate	X .023	X .033	X .042	X .052	X .06	X .0698
e. Subtotal (multiply c by d)	=	=	=	=	=	=
f. Amount to add	0	\$46	\$112	\$196	\$300	\$480
g. This is your Utah income tax. (Add lines e and f). Enter on line 17	=	=	=	=	=	=

Social Security Taxes - FICA

- FICA tax is a combination of a 6.2% social security tax and a 1.45% Medicare tax.
- The social security tax is assessed on wages up to \$97,500 in 2007 (changes every year); the Medicare tax is assessed on all wages.

Death and Transfer Taxes

- Federal taxes
 - Estate tax - imposed on property of deceased before transfer
 - Gift tax - on gifts transferred during life
- State taxes – varies by states
 - Inheritance tax - paid by beneficiary on property received
 - State estate tax

Federal Estate Tax Exemption

Death in	Top Rate	Exemption
2002	50%	\$1 million
2003	49%	\$1 million
2004	48%	\$1.5 million
2005	46%	\$2 million
2007	45%	\$2 million
2008	45%	\$2 million
2009	45%	\$3.5 million
2010	Repealed	
2011+	55%	\$1 million

Federal Gift Taxes

- Allows a tax-free \$10,000 per person gift from each person to each beneficiary per year.
 - Note that the \$10,000 limit is per person to each beneficiary (donee). So a husband and wife family with three children can give out a total of \$60,000 a year to their children without incurring tax. That is, each parent can give each child \$10,000 per year tax free.

Tax Planning

- Invest where you receive tax-advantaged income
 - Municipal bonds (tax-free interest)
 - Home (mortgage interest tax exempt, capital gain exemption)
- Split your income by giving out gifts
- Defer income to later years by setting up retirement arrangements (IRAs and others)

Special Tax Planning Considerations for Students

- Scholarships and Fellowships
- Employment related advantages
- Education Tax Credits
- Other Special Advantages
- For more information, click and read IRS's "[Parent and Student Guide to Federal Tax Benefits for Tuition and Fees](#) " and "[Business Deduction for Work-Related Education](#)"

Scholarships and Fellowships

- Awards that cover purely educational expenses that lead to a degree are most likely not taxable
- Payments for noneducational expenses are taxable
 - subsistence allowances paid to ROTC students in advanced training is an exception

Employment Related Advantages

- A qualified tuition reduction
 - Tuition reduction provided to employee or relative of employee
- Qualifying educational expenses
 - Must be required by employer to maintain or improve the skills needed in your current job
 - Cannot be used to prepare you for the minimal skills needed in your current position or prepare you for a new job
 - Itemized deduction that must exceed 2% of your adjusted gross income
- Qualified educational assistance
 - Includes educational expenses paid for by your employer
 - Your employer can tell you which expenses are qualified

Education Tax Credits

- Hope scholarship credit
 - For first two years of postsecondary education
 - Must be enrolled at least half-time in a degree program
 - Limit on maximum credit and phased out at higher incomes
- Lifetime learning credit
 - May receive this credit in years you do not qualify for the Hope Scholarship Credit
 - Limit on maximum credit and phased out at higher incomes

Other Special Tax Advantages

- Coverdell Education Savings Accounts (ESA)
 - \$2,000 per year (with income limits)
- State and private tuition programs
 - Visit [Utah Educational Savings Plan Trust](#)
- Student loan interest
 - Part of it may be tax deductible
- Education savings bonds
 - Series EE U.S. savings bonds issued after 1989

Please Check Out These Websites

- Learn more about taxes by visiting the Web site of "[Tax Foundation](#)".
- Visit the [IRS website: www.irs.gov](http://www.irs.gov)
- Visit the tax website for your state. If you live in Utah, the site is <http://incometax.utah.gov/>

Assignment for Chapter 4

- If you have never filed tax returns, fill out a Federal and a State (whichever state you are in) form using either your financial information, or your parents' financial information, or a hypothetical situation. Figure out the marginal tax rate.
- Review the tax return forms you filled out and match the terms with the terms taught in this chapter.