Unit 02. Determination of Tax

In this unit, we find out where we get the numbers that we use to fill out a Form 1040. When working through chapter 2, it will be helpful if you have a Form 1040 beside you (this form will become your new best friend this semester!). You can find one at http://www.irs.gov/pub/irs-pdf/f1040.pdf?portlet=3.

Reading for Unit 02 is PAK Chapter 2.

Outline

- Formula for individual income tax
- Deductions from adjusted gross income
- Determining the amount of tax
- Business income and business entities
- Treatment of capital gains and losses
- Tax planning considerations
- Compliance and procedural considerations

Formula for Individual Income Tax

Base Formula

\[
\text{Income from whatever source derived} - \text{Exclusions (see Table 2-2)} = \text{Gross Income}
\]

\[
\text{Gross Income} - \text{Deductions for AGI (see Table 2-4)} = \text{Adjusted Gross Income (AGI)}
\]

\[
\text{Adjusted Gross Income (AGI)} = \text{Greater of itemized deductions or standard deduction}
\]

\[
\text{Personal and dependency exemptions} = \text{Taxable Income}
\]

\[
\text{Tax rate or rates (tax table or schedule)} \times \text{Taxable Income} = \text{Gross tax}
\]

\[
\text{Credits and prepayments (see Table 2-5)} - \text{Gross tax} = \text{Net tax payable or refund due}
\]

Definitions

- **Income**: Includes both taxable and nontaxable income from whatever sources.
  - **Exclusions**: Any income that the tax law says is not taxable.
    - Example: Gifts and inheritance, life insurance proceeds, etc. See Table 12-2.
  - **Gross income**: Income reduced by exclusions.
    - **Deductions for AGI**: Allowable deductions generally for business and investment expenses.
      - Example: Deductions attributable to rents and royalties, etc. See Table 12-4.
  - **Adjusted Gross Income (AGI)**: A measure of income that falls between gross income and taxable income. AGI is an important concept because it is used in numerous other tax computations, especially to impose limitations.

Definitions Continued

- **Deductions from AGI (more details on later slides)**: Typically includes
  - Itemized deduction or standard deduction
  - Personal and dependency exemptions
  - Taxable income: AGI reduced by deductions from AGI. It is the amount of income that is taxed.
  - **Tax rates**: Tax rates are the percentage rates set by the Congress.
  - **Gross tax**: Taxable income times tax rates according to tax schedule. Most taxpayers use the tax table to find their gross tax.
  - **Credits and prepayments**: Amount that can be subtracted from gross tax.
    - **Refundable tax credits**: Can be used to reduce gross tax to zero. If some credit still remains, tax payer cannot receive a refund.
    - **Nonrefundable tax credits**: Can be used to reduce gross to zero. If some credit still remains, the tax payer cannot receive a refund.
  - **Payments**: Any tax payment already paid to the government for that tax year.
Tax Formula Illustrated

- The textbook has a good example on how to use the tax formula and Form 1040.
- Make sure you work through Example 2-1 about Larry and Jane Lane’s tax.
- PAK Pages 2-8 and 2-9 shows how this example is worked out on Form 1040.

Deductions for AGI

- Note the difference between deductions FOR AGI and deductions FROM AGI.
- Typically deductions FOR AGI are business and investment related. Although there are exceptions such as alimony paid.

Deductions from AGI

Itemized Deductions (Table 12-6, Example 12-2)

- The total of qualifying medical expenses, taxes, investment and residential interest, charitable contributions, personal casualty and theft losses, and miscellaneous deductions are claimed only if the total of such items exceeds the standard deduction.
- Deductions for medical expenses, charitable contributions, personal casualty and theft losses, and miscellaneous items are all limited by varying percentages of AGI.
- In 2009, total itemized deductions (excluding some expenses) are reduced by 1% of the taxpayer’s AGI over $166,800 ($83,400 for married/filing separately).
- Study Example I2-2.

Deductions from Adjusted Gross Income

Standard Deduction

- Standard Deduction varies based on:
  - Filing status, age, and vision
  - $5,700 - $11,400 in 2009 (see PAK first page)
  - Temporary increase in 2008 and 2009 by the amount of property tax up to $500 ($1000 if joint return)
  - Additions to the standard deduction are available for taxpayers who are older than 64 and/or blind.
  - The 2009 additions are $1,100 for married taxpayers and $1,400 for single taxpayers.

Deductions from Adjusted Gross Income

Standard Deduction or Itemized Deduction

- One can either take standard deduction or itemized deduction, depending on which one is larger.
- Study Example 2-3 and Example 2-4 to see when standard deduction and itemized deduction should be taken.
Deductions from Adjusted Gross Income

Limitations on Standard Deduction

- Some taxpayers are not permitted to use standard deduction as they possibly could receive an unintended benefit. For example:
  - Married filing separately – either both standard deduction or both itemized deduction.
  - Non resident alien
  - Study Example 2-5
- A special rule applies to taxpayers for whom he dependency exemption is allowable to another taxpayer.
  - Study Example 2-6 and Example 2-7

Personal Exemptions

- Generally, each taxpayer allowed one
  - Unless claimed as dependent on another return
  - $3,650 in 2009
  - Additional allowed for spouse on joint return

Deductions from Adjusted Gross Income

Dependency Exemptions: Requirements for All Dependents

- Taxpayers may claim a dependent exemption for each dependent. To qualify, an individual must meet the definition of either a qualifying child or a qualifying relative.
- All dependents must
  - Have a Social Security number reported on the return
  - Meet a citizenship test – U.S. citizens, residents, citizens of Canada or Mexico.
  - Meet a separate return rest – Married dependents cannot file joint returns.
  - Not themselves claim another person as a dependent.

Dependency Exemptions: Additional Requirements for Qualifying Children

- Relationship test - Be a natural, adopted, foster child, or stepchild of the taxpayer, a sibling of the taxpayer, or descendants of any of the previous;
- Age test - Be under 19, a full-time student under age 24, or a permanently and totally disabled child;
- Abode test - Have the same principal abode as the taxpayer;
- Support test – The qualifying child may not provide ½ of his or her own support during the year.
  - Study Example 2-8

Dependency Exemptions: Requirements for Other Relatives

- Relationship test
  - Be related to the taxpayer or reside in the taxpayer’s household for the entire year;
- Gross income test
  - Have gross income less than the exemption amount; and
- Support test
  - The taxpayer must normally provide more than ½ of a dependent’s financial support during the year. See also multiple support agreements on page 2-17.
  - Study Example 2-9, Example 2-10, Example 2-11, Example 2-12, 2-13, Example 2-14, Example 2-15, Example 2-16
**Deductions from Adjusted Gross Income**

**Dependency Exemptions: Multiple Support Agreements**

- When a group provides over 1/2 of the support of an individual but no one number of the group provides over 1/2 of the support, eligible members of the group are allowed to designate one group member to claim the exemption.

  - Study Example 2-17, Example 2-18, Example 2-19

**Dependency Exemptions: The Case of Divorce**

- In the case of divorce, the dependency exemption generally is awarded to the custodial parent. However, the non-custodial parent may claim exemption if ordered by the court or agreed upon by both parents.

  - Study Example 2-18, Example 2-19, Example 2-20.

**Dependency Exemptions: Phase-Out for High Income Taxpayers**

- Personal and dependency exemptions phased out for high income taxpayers
  - Phaseout has been gradually reduced and will be eliminated for 2010 & beyond

  - Study Example 2-21 and Example 2-22

**Child Credit**

- $1,000 per qualifying child
  - Under 17 and a "qualifying" child
  - Credit reduced if MAGI exceeds threshold
  - Child credit refundable to the extent of 15% of taxpayer's earned income in excess of $3,000

  - Study Example 2-23 and Example 2-24

**Determining the Amount of Tax**

- Gross tax is determined by applying the tax table (Appendix A) or tax rate schedule inside front cover to the taxpayer's taxable income.

- In 2009, tax brackets of 10%, 15%, 25%, 28%, 33%, and 35% are applicable to individual taxpayers. The income level covered by the five brackets varies with filing status.

  - Study Example 2-25 and Example 2-26

**Filing Status**

- There are five filing status categories:
  - Married filing jointly
  - Surviving spouse – for two years after the death of the spouse
  - Head of household – abandoned spouse can file under this category
  - Single
  - Married filing separately - It's an option for married couples, although in most of the cases separate returns will lead to more taxes.

- Relative tax liability by filing status from lowest to highest
  - Married filing jointly
  - Surviving spouse
  - Head of household
  - Includes abandoned spouse
  - Single
  - Married filing separately
Determining the Amount of Tax
Filing Status Issue: Abandoned spouse
- Abandoned spouse - A legally married individual may file as head-of-household if the individual:
  - lived apart from the spouse for the last 6 months of the year;
  - pays over half of the cost of maintaining a household in which the taxpayer and a dependent child lived for over half the year; AND
  - is a U.S. citizen or resident.
- Study Example 2-31 and Example 2-32

Filing Status Issue: Dependents with Unearned Income (e.g., interests, dividends)
- Three rules curtail the advantages of shifting income to dependents:
  - Dependents do not receive a personal exemption on their own returns. A dependent's standard deduction is reduced to $950 or his/her earned income + $300.
  - The tax on the net unearned income is figured by reference to the parents' tax rate if it is higher than the child's rate. This provision is often called the "Kiddie tax".
  - Whether Kiddie tax applies depends on the child's age:
    - <18, applies if the child's unearned income > $1,900
    - 18-23, unearned income > $1,900, earned income <= ½ of his or her support
    - 19-23, unearned income > $1,900, earned income <= ½ support, & full-time student
- Study Example 2-33 and Example 2-34
- When Kiddie tax applies, tax is computed using a three-step process:
- Study Example 2-35 and Example 2-36
- Parents of child subject to kiddie tax may elect to include child's dividend and interest income on their own return under certain conditions.

Business Income & Bus Entities
Type of Business and Tax Implications
- How business income is taxed depends on the type of business:
  - C Corporations pay income taxes at the entity level. Corporate returns are filed on Form 1120.
  - Flow-through entities do not pay taxes at the entity level.

C Corporation Formula
- C corporation formula:
  - Income from whatever source derived
  - Exclusions?
  - Gross Income
  - Deductions
  - Taxable Income
  - Tax rates
  - Gross Tax
  - Credits and prepayments
  - Net tax payable or refund due
- Study Example 2-37

C Corporation Tax Rates

| First $50K | 15% of Taxable Inc |
| > $50K But Not > $75K | $7,500 + 25% of Taxable Inc |
| > $75K But Not > $100K | 13,750 + 34% of Taxable Inc |
| > $100K But Not > $335K | $22,250 + 39% of Taxable Inc |
| > $335K | 34% of Taxable Inc |
| > $10M But Not > $15M | 3.4M + 35% of Taxable Inc |
| > $15M But Not > $18,333,333 | $5.150M + 38% |
| > $18,333,333 | 35% of Taxable Inc |

Capital Gains & Losses
Capital Asset Definition
- Capital asset defined in §1221
- Assets other than inventory, trade receivables, certain self-created works, depreciable business property, business land, and certain government publications
- Capital gains and losses are the gains or losses from the sale or exchange of capital assets.

To Avoid Capital Gain Taxes
Capital Gains & Losses
Long-term vs. Short-term

- Capital gains and losses are divided into 2 categories
  - Long-term is held for over 12 months – taxed at a maximum of 15%. 0% if in the 10% and 15% tax bracket through 2010
  - Short-term is held less than 12 months – taxed at the same rate as other income
- Net capital gain: All capital gains – all capital losses.
- Individuals can deduct up to $3,000 of net capital losses from their other income
- Unused losses are carried over indefinitely to offset gains in future years

Tax Planning Considerations

- Shifting income between family members
  - Shifting taxable income to family members to lower tax brackets will reduce the overall family tax burden.
  - Care must be taken to avoid assignment of income problems and sham transactions (i.e. certain “family trusts”).
  - Study Examples 2-38, 2-39, 2-40, and 2-41
- Splitting income
  - Creating additional taxpayers may reduce the overall tax burden, but administrative costs will reduce the overall savings.
  - Study Example 2-42

Maximizing itemized deductions
- Grouping a specific type of deductible expense in one tax year can increase the total amount deductible
- Favorable timing for medical expenses, casualty and theft losses, and miscellaneous deductions may not be the same tax year as for significant charitable contributions because of an adjusted gross income floor for the first three itemized deductions mentioned, and an adjusted gross income limitation for charitable contributions.
- Study Examples 2-43 and 2-44

Filing joint or separate returns
- Several factors affect the decision of whether married couples should file jointly or separately (i.e. itemized deduction position)
- Study Examples 2-45, 2-46, and 2-47.

Compliance and Procedural Considerations

- Who must file
  - Generally, the income limitation for filing can be determined by adding the standard deduction for a particular status to the amount for personal exemptions for that status
  - Study Example 2-48
- Due dates for filing return
  - Individuals and Partnerships: 15th day of 4th month after year end
  - Forms 1040, 1040EZ, and 1040A
  - Corporations: 15th day of 3rd month after year end
  - Systems for Reporting Income
    - Payments made by certain entities are reported to the IRS for computer cross checking that all income has been reported.
    - Items reported include pensions, annuities, wages, dividends, interest, sales of securities, unemployment compensation, rents, royalties, and lump-sum distributions from retirement plans.

Addition Things to Study

- Answers to Selected Textbook Problems:
  - 2-1, 2-3, 2-12, 2-13, 2-19, 2-32, 2-38, 2-43, 2-55, 2-64
  - http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit02.pdf
- Self-study Quizzes on Publisher’s website
- Homework Assignment for Unit02 (Graded)
  - PAK, Chapter 2 Problems: 2-29, 2-30, 2-34, 2-39, 2-53, 2-56, 2-63
  - Please go to Week 2 folder on course Homepage to find the link. You can also access it directly through the “Assignments” link.
- Discussion Topic for Unit02(Graded)
  - Don’t forget to post your thoughts on the discussion topic of the week.
  - Go to the Week 2 folder on course Homepage to find the link. You can also access it directly through the “Discussions” link.