

1

Unit 12. Special Tax Computation Methods, Tax Credits, and Payment of Tax [Pak Ch. 14]

This chapter covers several topics: the Alternative Minimum Tax, Tax Credits, and Tax Payments.



Outline

2

1. Alternative minimum tax
2. Self-employment tax
3. Overview of tax credits
4. Nonrefundable personal tax credits
5. Miscellaneous credits
6. General business credits
7. Refundable credits
8. Payment of taxes
9. Tax planning considerations
10. Compliance and procedural considerations

1. Alternative Minimum Tax

General information

3

- As the number of special tax provisions increased over the years, many taxpayers were able to carefully plan in order to substantially reduce or eliminate their entire income tax liability.
- In 1969, Congress passed rules to ensure all taxpayers would pay at least a minimum amount of income tax, called the Alternative Minimum Tax (AMT)
- The current alternative minimum tax (AMT) applies only if the calculated AMT exceeds the taxpayer's regular tax liability. Most taxpayers do not pay AMT because of the liberal exemption and insufficient tax preferences.

1. Alternative Minimum Tax

AMT rates and tax base (Ex. 14-3)

4

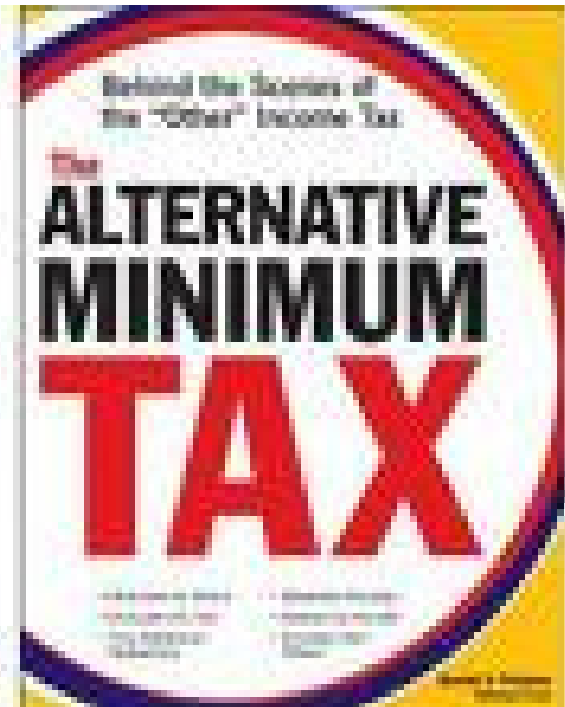
- AMT tax rate:
 - ▣ 26% for statutory tax base of \$175,000 or less.
 - ▣ 28% for the amount of statutory tax base exceeding \$175,000
- The statutory tax base = AMTI - applicable exemption
- AMTI (Alternative minimum taxable income) consists of
 - ▣ taxable income plus tax preference items, certain nondeductible losses, personal exemptions; plus or minus other adjustments for different AMT calculations of certain taxable income items.
- The AMT exemption amount is
 - ▣ \$69,950 for married-joint/surviving spouse;
 - ▣ \$44,200 for single, and
 - ▣ \$34,975 for married-separate.
 - ▣ The exemption amount is reduced for certain high income taxpayers.

1. Alternative Minimum Tax

AMT Tax Preference Items (Ex. 14-4)

5

- AMT tax preferences include excess depreciation over straight-line and tax-exempt interest on certain private activity bonds.
- Not all tax preferences generate AMTI (i.e. tax-exempt interest is not part of AMTI except for tax-exempt interest on certain private activity bonds).



1. Alternative Minimum Tax

AMT Adjustments (Ex. 14-5, 14-6)

6

- AMT adjustments include limitations on itemized deductions and adjustments due to timing differences (i.e., different timing for long-term contracts, depreciation, and research expenses).
- Itemized deductions not qualifying for reduction of AMTI include state, local, and foreign income taxes, real and personal property taxes, and miscellaneous itemized deductions.

1. Alternative Minimum Tax

More AMT information

7

- For more information and links about AMT go to <http://www.irs.gov/taxtopics/tc556.html>



2. Self-Employment Tax

General information (Ex. 14-8, 14-9, 14-10)

8

- Employees and their employer pay FICA, while self-employed individuals pay a comparable amount in self-employment tax.
 - ▣ Individuals with self-employment earnings of \$400 or more are subject to self-employment tax. Rates vary with the tax year involved.
 - ▣ For 2009, the net self-employment tax rate is 15.3% on the first \$106,800 of self-employment earnings.
 - ▣ For 2009, the self-employed taxpayer must also pay 2.9% of self-employment income in excess of \$106,800 as additional Medicare insurance.
 - ▣ The taxpayer receives a trade or business deduction for one-half of the self-employment taxes paid.

2. Self-Employment Tax

What Constitutes Self-Employment Income (Ex. 14-11)

9

- Self-employment income includes total earnings from a sole proprietorship, partnership income (distributive share plus guaranteed payments), director fees, and taxable research grants.
- Self-employment income must be computed separately for husband and wife on a joint return.

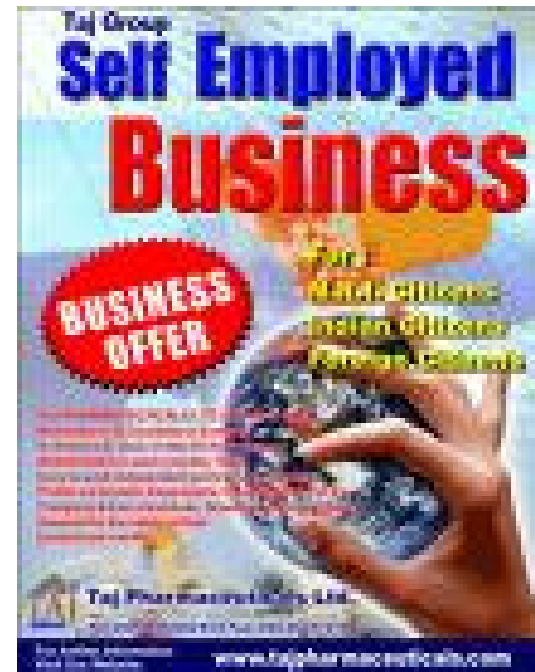
2. Self-Employment Tax

More information

10

□ For more information and links go to

<http://www.irs.gov/businesses/small/article/0,,id=98846,00.html>



3. Overview of Tax Credits

Use and Importance of Tax Credits (Table 14-1)

11

- Tax credits may be used to implement tax policy objectives.
 - ▣ EXAMPLE:
 - Increase employment - Work Opportunity Credit
 - Encourage research and development - Credit for Research Activities
 - Provide tax relief for low income taxpayer - Earned Income Credit
- Study Topic Review 14-2

3. Overview of Tax Credits

Value of a Credit Versus a Deduction (Ex. 14-12)

12

- The value of a deduction is dependent on the taxpayer's marginal rate, but a credit reduces tax liability dollar for dollar.



4. Personal Tax Credits

Child Tax Credit

13

- In 2009, taxpayers are entitled to a \$1,000 credit for each qualifying child under the age of 17. Phase-outs of the credit begin at \$75,000 AGI for single taxpayers and \$110,000 AGI for married/filing jointly.
- For more information and updates go to <http://www.irs.gov/publications/p972/index.html>



4. Personal Tax Credits

Child and Dependent Care Credit (Ex. 14-14, 14-16, 14-17)

14

- A 20-35% credit (depending on AGI) is available for qualifying employment-related child care expenses.
- The maximum expenses for calculation are \$3,000 for a single qualifying dependent and \$6,000 for multiple qualifying dependents. Maximum qualifying expenses are limited by individuals earned income. Amounts are also reduced for any income exclusion from a qualified dependent care assistance program.
 - ▣ EXAMPLE: The taxpayer expends \$8,000 in child care for two children, ages 4 and 6. The taxpayer's AGI (all earned income) is \$50,000. The taxpayer's child care credit is \$1,200 (\$6,000 maximum expenses x 20% credit rate for this AGI level).
- For more information and updates go to <http://www.irs.gov/pub/irs-pdf/p503.pdf>

4. Personal Tax Credits

Tax Credits for the Elderly and Disabled

15

- ❑ For certain low-income elderly (65 or older) or who have retired because of permanent disability.
- ❑ Most elderly or disabled are ineligible due to income ceiling limits.
- ❑ The credit is 15% of an initial amount of \$5,000 (\$7,500 for married filing jointly).
- ❑ The amount is reduced by several incomes, including Social Security, VA pension, etc.
- ❑ For more information go to <http://www.irs.gov/instructions/i1040sr/ar01.html>

4. Personal Tax Credits

Adoption Credit (Ex. 14-19)

16

- A credit for qualified adoption expenses is available. The general limit for the credit is \$12,150. The credit is phased-out ratably for modified AGI's between \$182,180 and \$222,180.
- For more information go to <http://www.irs.gov/taxtopics/tc607.html>



4. Personal Tax Credits

American opportunity tax credit

17

- The new credit modifies the existing Hope Credit for tax years 2009 and 2010, making the Hope Credit available to a broader range of taxpayers.
- The act specifies:
 - ▣ Provisions are specific to tax years 2009 and 2010 for the first 4 years of post-secondary education.
 - ▣ Increases the Hope Scholarship Credit to 100 percent qualified tuition, fees and course materials paid by the taxpayer during the taxable year not to exceed \$2,000, plus 25 percent of the next \$2000 in qualified tuition, fees and course materials. The total credit does not exceed \$2500.
 - ▣ 40% of the credit is refundable.
 - ▣ This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of \$80,000 (\$160,000 for married couples filing jointly).
- For more information go to <http://www.irs.gov/newsroom/article/0,,id=205674,00.html>

4. Personal Tax Credits

Lifetime Learning Credit (Ex. 14-20)

18

- Under certain circumstances taxpayers are allowed a 20% credit against a \$10,000 maximum amount of tuition and fees. The limitation is applied at the taxpayer level.
- This credit is available for any number of years the qualifying expenses are paid.
- No doubling up with the HOPE credit is allowed.
- The phase-out rules are the same as the HOPE credit rules.
- For more information go to <http://www.irs.gov/individuals/article/0,,id=96273,00.html>

4. Personal Tax Credits

Qualified Retirement Savings Contributions Credit (Ex. 14-22)

19

- The temporary nonrefundable credit is available to encourage low and middle income taxpayers to save for retirement.
- The credit is calculated by multiplying the credit percentage (50%, 20%, 10%, or 0% depending on AGI) times the taxpayer's qualified plan contributions (qualified contributions are limited to \$2,000 per person for this calculation).
- Those taxpayers under 18 years of age, full-time students, and dependents on someone else's return are not eligible for the credit.
- For more information go to <http://www.irs.gov/newsroom/article/0,,id=107686,00.htm>
!

5. Miscellaneous Credits

Foreign Tax Credit

20

- A foreign tax credit is allowed to avoid double taxation on income subject to U.S. and foreign tax.
 - ▣ Computation of Allowable Credit (Ex. 14-23)
 - The foreign tax credit is limited to the lesser of foreign tax paid or the portion of U.S. tax liability attributable to income earned in foreign countries.
 - ▣ Treatment of Unused Credits
 - Unused foreign tax credits are available for a 2-year carryback and a 5-year carryover.
- For more information go to <http://www.irs.gov/taxtopics/tc856.html>

6. General Business Credits

- The general business credit may not exceed the “net income tax” minus the greater of (1) the tentative minimum tax or (2) 25% of the “net regular tax liability” above \$25,000.
- Unused general business tax credits arising after 1997 are available for a 1-year-carryback and a 20-year carryforward.
- For more information go to <http://www.irs.gov/businesses/small/article/0,,id=99839,00.html>

6. General Business Credits

Employer-Provided Child Care Credit (Ex. 14-27)

22

- Employers may be eligible for a credit based on the total of 25% of qualified child care expenses (operating and employee facility) plus 10% of qualified child care resources and referral expenditures.
- The credit is limited to \$150,000 annually and is also limited by the general business credit limitation.

6. General Business Credits

Credit for Research Activities

23

- ❑ The credit for increasing research activities was extended through December 31, 2009.
- ❑ This credit has not been extended by Congress at the date of printing. The credit can be computed under prior rules or a relatively new three-tiered alternative approach.



7. Refundable Tax Credits

Earned income credit (EITC or EIC)

24

- ❑ The EITC is a refundable income tax credit for low to moderate income working individuals and families.
- ❑ Congress originally approved the tax credit legislation in 1975 in part to offset the burden of social security taxes and to provide an incentive to work.
- ❑ To qualify for Earned Income Tax Credit or EITC, you must have earned income. In addition, you must either meet the additional rules for Workers without a Qualifying Child or have a child that meets all the Qualifying Child Rules for you.
- ❑ For EITC Income Limits, Maximum Credit Amounts and Tax Law Updates go to:
<http://www.irs.gov/individuals/article/0,,id=150513,00.html>

7. Refundable Tax Credits

First-time homebuyers credit (FTHC)

25

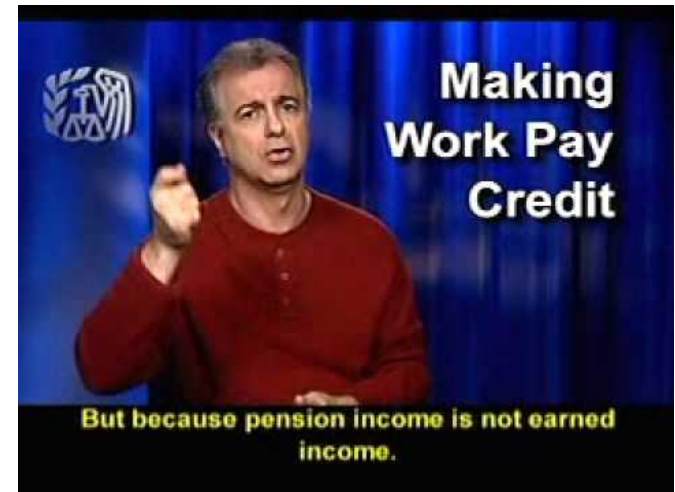
- The *Housing and Economic Recovery Act of 2008* created a new refundable tax credit, beginning in 2008, for individuals who are qualified first-time homebuyers of a principle residence in the United States. The *American Recovery and Reinvestment Act of 2009* made changes to the credit for qualified purchases made in 2009.
- For more information go to <http://www.irs.gov/taxtopics/tc612.html>

7. Refundable Tax Credits

3) Making work pay credit & economic recovery payments

26

- For information on making work pay credit go to <http://www.irs.gov/newsroom/article/0,,id=204447,00.html>
- For information on economic recovery payments go to <http://www.irs.gov/newsroom/article/0,,id=204468,00.html>



8. Payment of Taxes

1) Withholding of Taxes (Ex. 14-35)

27

- Generally, employers are required to withhold federal income taxes and FICA tax from employee compensation. This procedure is not necessary for independent contractors.
- Compensation for withholding purposes includes salaries, commissions, fees, bonuses, termination payments, vacation pay, and taxable fringe benefits.
- Special rules are provided for multiple employers during the same year, certain employment categories (i.e., ministers, servants), certain fringe benefits, and lump-sum pension or annuity payments.

8. Payment of Taxes

2) Estimated Tax Payments

28

- Taxpayers must make estimated tax payments on income not subject to withholding or face the possibility of underpayment penalties.
- To avoid penalties for underpaid tax, the taxpayer can:
 - ▣ Estimated tax for the current year is less than \$1,000
 - ▣ Pay 90% of the tax due for the current year (either actual or computed on an annualized basis)
 - ▣ Pay 100% of the actual tax liability for the prior year. (110% of prior year if prior year AGI exceeded \$150,000).

9. Tax Planning Considerations

29

- Avoiding the Alternative Minimum Tax
 - ▣ Judicious timing of income and expense items may avoid imposition of the Alternative Minimum Tax.
- Avoiding the Underpayment Penalty for Estimated Tax (Ex.14-39)
 - ▣ The easiest method of avoiding the underpayment penalty for estimated tax in many situations is to pay 100% of the actual prior year liability (assuming prior year AGI doesn't exceed \$150,000).
- Cash-Flow Considerations
 - ▣ To maximize cash flow to the taxpayer, withholding and/or estimated payments should be adjusted to avoid overpayments.
- Utilization of General Business Tax Credits
 - ▣ In order to achieve maximum utilization of business tax credit, the interrelationship of the various credits must be considered.
- Foreign Tax Credits and Exclusion
 - ▣ Taxpayers with foreign job assignments may choose between a foreign tax credit and a foreign-earned income exclusion.

10. Compliance & Procedural Considerations

30

- Alternative Minimum Tax Filing Procedures
 - ▣ Individuals compute the AMT on Form 6251.
- Withholding and Estimated Tax (Ex. 14-40)
 - ▣ Taxpayer withholdings are indicated on Form W-2 or W-2P.
- General Business Tax Credits
 - ▣ General business tax credits use Forms 3800, 3468, and 4255.
- Personal Tax Credits
 - ▣ Personal tax credits require Forms 2441, Schedule R, W-5, and 1116.