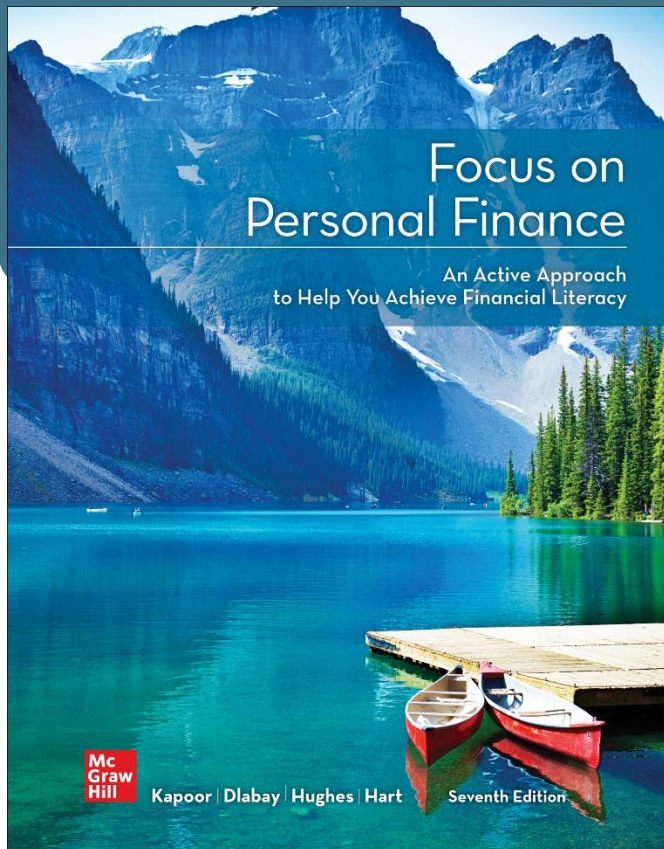




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# Chapter 3

## Taxes in Your Financial Plan



# Taxes in Your Financial Plan

## Chapter Learning Objectives

- LO3.1** Identify the major tax types in our society.
- LO3.2** Calculate taxable income and the amount owed for federal income tax.
- LO3.3** Prepare a federal income tax return.
- LO3.4** Select appropriate tax strategies for various life situations.



# Planning Your Tax Strategy

## LO3.1

- Tax planning should be an ongoing process throughout the year
  - Tax planning starts with knowing current tax laws, maintaining complete and appropriate tax records, then making purchase and investment decisions that can reduce your tax liability
  - “Tax Freedom Day” has recently been in mid-April and represents the portion of the year people work to pay their taxes

**Primary goal: Pay your fair share of taxes, but take advantage of tax benefits**



# Types of Tax

- Taxes on purchases
  - You pay *sales tax* on many purchases
  - In recent years, all but five states had a general sales tax
  - An **excise tax** is imposed by federal and state governments on specific goods and services, such as gasoline, cigarettes, alcoholic beverages, tires, and air travel
- Taxes on property
  - *Real estate property tax* is based on the value of land and buildings
  - Some areas impose a *personal property tax* on the value of automobiles, boats, furniture, farm equipment, and even livestock



# Types of Tax (Continued)

- Taxes on wealth
  - An **estate tax** is imposed on the value of a person's property at the time of death
    - Federal tax
  - An **inheritance tax** is levied on the value of property bequeathed by a deceased person
    - State tax
- Taxes on earnings
  - For most people, Social Security tax is 6.2% and Medicare tax is an additional 1.45%, for a total of 7.65%
    - Employers must make equal contributions
  - Income tax may be levied by federal, state, and local governments
    - Only seven states do not have a state income tax



# The Basics of Federal Income Tax

## LO3.2

### Step 1: Determining Adjusted Gross Income

- This process starts with steps to determine **taxable income**, which is the net amount of income, after allowable deductions, on which income tax is computed
- Gross, or total, income can consist of three main components:
  - **Earned income** is usually in the form of wages, salary, commission, fees, tips, or bonuses
  - **Investment income** (i.e., portfolio income) is money received in the form of dividends, interest, or rent from investments
  - **Passive income** results from business activities in which you do not actively participate, such as a limited partnership, or rental property that you do not actively manage



# The Basics of Federal Income Tax (Continued)

## Step 1: Determining Adjusted Gross Income

- Total income is affected by **exclusions**, an amount not included in gross income
- Exclusions may also be referred to as **tax-exempt income**, income that is not subject to tax
  - Example: Interest earned on most state and city bonds is exempt from federal income tax
- **Tax-deferred income** is income that will be taxed at a later date
  - Example: Amounts invested in a retirement account will be taxed when it is withdrawn in the future



# Adjustments to Income

- **Adjusted gross income (AGI)** is gross income after certain reductions, called *adjustments to income*, have been made
- Adjustments to income include the following:
  - Contributions to an individual retirement account (IRA) or a Keogh retirement plan
  - Penalties for early withdrawal of savings
  - Alimony payments (per divorce decree before December 31, 2018)
- **Tax shelters** are investments that provide immediate tax benefits and a reasonable expectation of a future financial return



# Taxable Income

## Step 2: Computing Taxable Income

- A **tax deduction** is an amount subtracted from adjusted gross income to arrive at taxable income
  - Every taxpayer receives at least the **standard deduction**, a set amount on which no taxes are paid
    - As of 2020, single people receive a standard deduction of \$12,400 (married couples filing jointly receive \$24,800)
    - Blind people and individuals 65 and older receive higher standard deductions
  - Some people may qualify for **itemized deductions**, expenses a taxpayer is allowed to deduct from adjusted gross income
    - Common itemized deductions include medical and dental expenses, taxes, interest, contributions, and casualty and theft losses

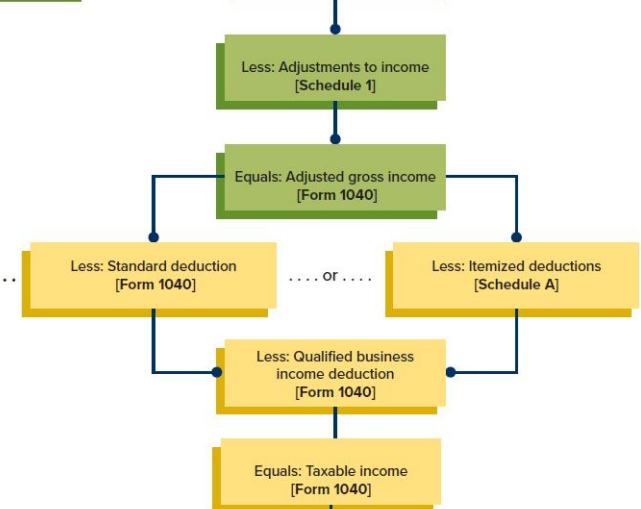
# Computing Taxable Income and Your Tax Liability

## Exhibit 3-1

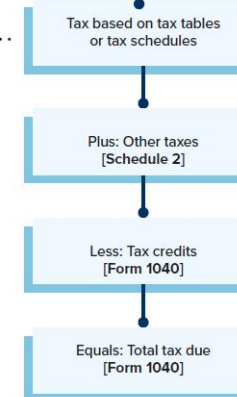
### Step 1: Determining Adjusted Gross Income .....



### Step 2: Computing Taxable Income .....



### Step 3: Calculating Taxes Owed .....



### Step 4: Making Tax Payments Step 5: Deadlines and Penalties

# A Tax Recordkeeping System

## Exhibit 3-2

### Tax Forms and Filing Information

- ☐ Current tax forms and instruction booklets and online resources
- ☐ Reference books on current tax laws and tax-saving techniques
- ☐ Social Security numbers of household members
- ☐ Copies of federal tax returns from previous years

### Income Records

- ☐ W-2 forms reporting salary, wages, and taxes withheld
- ☐ W-2P forms reporting pension income
- ☐ 1099 forms reporting interest, dividends, and capital gains and losses from savings and investments
- ☐ 1099 forms for self-employment income, royalty income, and lump-sum payments from pension or retirement plans

### Expense Records

- ☐ Receipts for medical, dependent care, charitable donations, and job-related expenses
- ☐ Mortgage interest (Form 1098) and other deductible interest
- ☐ Business, investment, and rental-property expense documents



# Taxes Owed

## Step 3: Calculating Taxes Owed

- Your taxable income is the basis for computing the amount of tax owed
  - **Marginal tax rates** are used to calculate tax on the last (and next) dollar of taxable income
  - **Average tax rates** are based on the total tax due divided by taxable income
- Each of the tax rates represents a range of income level, often referred to as “brackets”
  - To calculate the tax on a specific amount of income, you must calculate the tax from each of the brackets as you progress up to your taxable income

# 2020 Federal Income Tax Table

| Rate on Taxable Income | Single Taxpayers    | Married Taxpayers Filing Jointly | Heads of Household  |
|------------------------|---------------------|----------------------------------|---------------------|
| 10%                    | Up to \$9,875       | Up to \$19,750                   | Up to \$14,100      |
| 12%                    | \$9,876–\$40,125    | \$19,751–\$80,250                | \$14,101–\$53,700   |
| 22%                    | \$40,126–\$85,525   | \$80,251–\$171,050               | \$53,701–\$85,500   |
| 24%                    | \$85,526–\$163,300  | \$171,051–\$326,600              | \$85,501–\$163,300  |
| 32%                    | \$163,301–\$207,350 | \$326,601–\$414,700              | \$163,301–\$207,350 |
| 35%                    | \$207,351–\$518,400 | \$414,701–\$622,050              | \$207,351–\$518,400 |
| 37%                    | Over \$518,401      | Over \$622,051                   | Over \$518,401      |

# Tax Due: An Example

## Tax Due for Married Filing Jointly (\$95,000 taxable income)

### 10% Bracket

- Range of income (\$0 – \$19,750)
- $\$19,750 \times 10\% = \$1,975$

### 12% Bracket

- Range of income (\$19,751– \$80,250)
- $\$60,499 \times 12\% = \$7,260$

### 22% Bracket

- Range of income (\$80,251– \$95,000)
- $\$14,749 \times 22\% = \$3,245$

### Total Tax Due

- Total tax due (all brackets)
- $\$1,975 + \$7,260 + \$3,245 = \$12,480$



# Taxes Owed (Continued)

## Step 3: Calculating Taxes Owed

- *Alternative minimum tax (AMT)* is designed to ensure those who receive tax breaks also pay their fair share of taxes
  - Originally designed to prevent those with high incomes from using special tax breaks to pay little in taxes
  - Recently, more taxpayers have been impacted by this tax
- **Tax credits** are subtracted directly from the amount of taxes owed
  - Example: *Earned-income credit (EIC)* is for working parents with taxable income under a certain amount
  - Tax credits differ from deductions in that tax credits have a full dollar effect in lowering taxes, whereas a deduction reduces the taxable income on which the tax liability is computed



# Tax Payments

## Step 4: Making Tax Payments

- You pay federal income taxes through either payroll withholding or estimated tax payments
  - *Withholding* requires an employer to deduct federal income tax from your pay
    - Withheld amount is based on the number of exemptions and the expected deductions claims
    - After the end of the year, you will receive a W-2 form, which reports your annual earnings and the amounts deducted for taxes
  - *Estimated payments* may be required if income is received from savings, investments, independent contracting, royalties, and pension payments
    - This income is reported on Form 1099



# Deadlines and Penalties

## Step 5: Deadlines and Penalties

- Most people are required to file a federal income tax return by April 15
  - If you are unable to file on time, you can use Form 4868 to obtain an automatic six-month extension
  - An extension is for the 1040 form (and other documents), but it does not delay your payment liability
  - Estimated amount owed, along with Form 4868, must be filed by April 15 or penalties may be assessed
- Refunds may be claimed several months (or years) late, and the IRS will pay you interest
  - Refunds must be claimed within three years of filing the return or within two years of paying the tax



# Filing Your Federal Income Tax Return

## LO3.3

- Who must file a federal income tax return?
  - Every citizen or resident of the U.S. (and every U.S. citizen who is a resident of Puerto Rico) is required to file if their income is above a certain amount
- Filing status is affected by marital status and dependents:
  - Single
  - Married, filing joint return
  - Married, filing separate returns
  - Head of household
  - Qualifying widow or widower



# Which Tax Forms and Schedules Should You Use?

- Tax Cuts and Jobs Act simplified the basic form used when filing your taxes
  - Previously, there were three basic forms to choose from – Form 1040, Form 1040EZ, and Form 1040A
  - Now, there is only one basic form, Form 1040, to report your income
  - If you are 65 or older, you may also use the Form 1040-SR, which is the same as Form 1040 but with larger print and a standard deduction chart for seniors and those with blindness
- Approximately **800** additional federal tax forms and schedules that are used to report additional income, deductions, extra taxes, and more complex tax situations



# Completing the Federal Income Tax Return

- Major sections of Form 1040:
  1. Filing status
  2. Income
  3. Additional (other) income
  4. Adjustments to income
  5. Tax computation
  6. Other taxes
  7. Payments
  8. Tax credits
  9. Refund or amount you owe
  10. Your signature



# What if I Made an Error on My Federal Tax Return?

- Form 1040X is used to amend a previously filed tax return
  - Necessary if you discover income that was not reported or if you find additional deductions that will change your taxable income
  - Not recommended that you wait for the IRS to notify you that they found a difference, as it could cost you penalties and interest



# How Do I File My State Tax Return?

- All but seven states have some type of state income tax
  - Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not assess state income taxes
  - Most states' tax rates range from 1 to 10 percent
  - States usually require income tax returns to be filed when the federal Income tax return is due



# How Do I File My Taxes Online?

- More common than paper filing
- IRS reports the filing of federal taxes now exceeds 138 million returns annual, which is over 90% of total tax returns
- E-filing refunds usually take 3 weeks
  - Cost for e-filing is usually between \$15 – \$40, with no fee in some cases



# How Do I File My Taxes Online?

## (Continued)

- Through the Free File Alliance, online tax preparation and e-filing are available free to millions of taxpayers
- Online filing process involves the following steps:
  1. Go to [www.irs.gov](https://www.irs.gov) and click “Do Your Taxes For Free”
  2. Determine eligibility and read “How to Use Free File”
  3. Connect to the chosen company’s website to begin
  4. Use the company’s online software to prepare return



# Tax Preparation Software

- When selecting tax software, consider the following factors:
  1. Personal situation
  2. Special tax situations
    - Types of income
    - Unusual deductions
    - Tax credits
  3. Features in the software
    - “Audit check”
    - Future tax planning
    - Filing federal and state tax forms online
  4. Technical aspects
    - Hardware and operating system requirements
    - Online support



# What Tax Assistance Services are Available?

- IRS Services
  1. Publications
    - 1-800-TAX-FORM
    - [www.irs.gov](http://www.irs.gov)
  2. Recorded messages
    - 1-800-829-4477
  3. Phone hotline
    - 1-800-829-1040
  4. Walk-in service
  5. Interactive tax assistant
  6. DVD
  7. IRS2Go App



# What Tax Assistance Services are Available?

## (Continued)

- Tax publications
  - Each year, several tax guides are published and offered for sale:
    - *J.K. Lasser's Your Income Tax*
    - *The Ernst & Young Tax Guide*
    - *Your Federal Income Tax (for Individuals)* - free from IRS
- Online resources
  - Be sure to use reliable websites and print information for your records



# Tax Preparation Services

## **Types of tax services:**

- Tax services range from one-person, local operations to national firms with thousands of offices, such as H&R Block
- Enrolled agents - government-approved tax experts
- CPA tax accountants
- Attorneys may be used when you are involved in a tax-related transaction or when you have a difference of opinion with the IRS
- Volunteer Income Tax Assistance (VITA) offers free tax help to low- and moderate-income taxpayers who cannot prepare their own tax returns



# Evaluating Tax Services

## Factors to consider:

- Training and experience of the tax professional
- How will the fee be determined?
- Are questionable deductions suggested?
- If return is audited, will the preparer represent the client?
- Is tax preparation the main business activity, or is it a front for other financial products?
- Additional information may be obtained at the websites for the National Association of Enrolled Agents ([www.naea.org](http://www.naea.org)) and the National Association of Tax Professionals ([www.natptax.com](http://www.natptax.com))



# Tax Service Warnings

- Ultimately you are responsible for providing complete and accurate information
  - If your professional tax preparer makes a mistake, you are still responsible for paying the correct amount, plus any interest and penalties
- Hiring a tax preparer does not guarantee that you will pay the *correct* amount
- Beware of tax preparers that offer refunds in advance
  - “Refund anticipation loans” can charge interest rates in excess of 300%



# What If Your Return Is Audited?

- A **tax audit** is a detailed examination of your tax return by the IRS
- In most audits, the IRS requests additional information to support your return
- Keep accurate records
  - Receipts, canceled checks, and other evidence can verify amounts that you claim



# How to Avoid Common Filing Errors

## Exhibit 3-7

### **For All Returns**

- Organize all tax-related information for easy access.
- Be sure to include the correct Social Security number(s).
- Follow instructions carefully. Many people deduct total medical and dental expenses rather than the amount of these expenses that exceeds 10 percent of adjusted gross income.
- Use the proper tax rate schedule or tax table column.
- Be sure to claim the correct amounts for standard deductions for your filing status.
- Consider the alternative minimum tax that may apply to your situation. Be sure to pay self-employment tax and tax on early IRA withdrawals.
- Check your math several times. Also spot-check the tax software to ensure accuracy.
- Keep a copy of your return.
- Check everything again—and file on time!

### **For Paper Returns**

- Sign your return (both spouses must sign a joint return) or the IRS won't process it.
- Be sure to record amounts on the correct lines.
- Attach necessary documentation such as your W-2 forms and required supporting schedules.
- Make the check payable to "United States Treasury."
- Put your Social Security number, the tax year, and a daytime telephone number on your check—and be sure to sign the check!
- Put the proper postage on your mailing envelope.



# What If Your Return Is Audited?

## (Continued)

- Less than 1% of all tax filers are audited each year
- If you claim large or unusual deductions, you are more likely to be audited
- Three types of audits:
  1. *Correspondence audit* is a mail inquiry requiring you to clarify or document minor questions
  2. *Office audit* requires you to visit an IRS office to clarify some aspect of your return
  3. *Field audit* is more complex, with an IRS agent visiting you at your home, your business, or your accountant's office in order to access your records



# What If Your Return Is Audited?

## (Concluded)

- When you receive an audit notice, you have the right to request time to prepare
- You can also ask the IRS for clarification of items being questioned
- When audited, follow these suggestions:
  - Decide whether you will bring tax preparer, accountant, or lawyer
  - Be on time; bring only relevant documents
  - Present tax evidence in a logical, calm, and confident manner
  - Make sure the information you present is consistent with tax law
  - Keep your answers aimed at the auditor's questions



# Tax Planning Strategies

## LO3.4

- Practice **tax avoidance**, the use of legitimate methods to reduce your tax obligation
  - If you expect to have the *same* or a *lower* tax rate next year, *accelerate deductions* into the current year
  - If you expect to have a *lower* or the *same* tax rate next year, *delay the receipt of income* until next year
  - If you expect to have a *higher* tax rate next year, consider *delaying deductions*
  - If you expect to have a *higher* tax rate next year, *accelerate the receipt of income*
- **Tax evasion** is the use of illegal actions to reduce one's taxes



# Education Deduction or Tax Credit?

- If you have paid higher education costs this year, consider the following options:
  - **Tuition and Fees deduction**
    - Allows you to reduce your AGI by as much as \$4,000 for expenses paid in the current year
  - **American Opportunity Credit**
    - Allows a credit of up to \$2,500
    - Limited to the first four years of postsecondary education
    - Student must be enrolled at least half-time
  - **Lifetime Learning Credit**
    - Limited to \$2,000
    - Can be used for part-time education and graduate school funds, as well as postsecondary education beyond the first four years



# Consumer Purchasing

- Place of residence
  - Owning a home is one of the best tax shelters
  - Both real estate property taxes and interest on the mortgage (up to \$750,000 of the debt) are deductible (as itemized deductions) and thus reduce taxable income
- Consumer debt
  - *Home equity loans*, which are *second mortgages*, must be used to invest in improvements or other expenses associated with the home in order to be eligible
- Health care expenses
  - *Flexible spending accounts*, *health savings accounts*, and expense reimbursement accounts allow you to reduce your taxable income when paying for medical expenses or child care costs



# Investment Decisions

## Tax-exempt investments

- Interest income from municipal bonds, which are issued by state and local governments, and other tax-exempt investments is not subject to federal income tax

## Tax-deferred investments

- *Tax-deferred annuities* are usually issued by insurance companies
- *Health savings accounts* may be utilized for current health care expenses or for retirement in future years
- *Retirement plans*, such as IRA, SEP-IRA, or 401(k) plans
- **Capital gains** are profits from the sale of a capital asset such as stocks, bonds, or real estate



# Investment Decisions

## (Continued)

### **Self employment**

- Self-employed persons may deduct expenses such as health and certain life insurance as business costs
- TCJA may allow you to deduct up to 20% of the income due to the Qualified Business Income deduction
- Recall, business owners also must pay self-employment tax in addition to the regular tax rate

### **Children's investments**

- Children under 18 or a full-time student under 24 with investment income of more than \$2,200 is taxed at parents' top rate
- For investment income under \$2,200, child receives a deduction of \$1,100, and the next \$1,100 is taxed at his or her own rate



# Retirement and Education Plans

- **Traditional IRA**

- Available to people who do not participate in employer-sponsored retirement plans or who have an AGI under a certain amount

- **Roth IRA**

- Limited to people with an AGI under a certain amount
- Contributions are not tax deductible, but the earnings on the account are tax-free after five years

- **SEP-IRA plan**

- Self-employed individuals can establish a Simplified Employment Pension (SEP-IRA) plan
- Allows contributions by the employer for employees that are at least 21 and have worked at least three of the last five years



# Retirement and Education Plans

## (Continued)

- **401(K) plan**
  - Tax-deferred retirement plan sponsored by an employer that allows you to contribute a greater tax-deferred amount than you can contribute to an IRA
- **Coverdell education savings account**
  - Designed to assist parents in saving for the education of their children
  - Withdrawals can be used for a variety of educational uses for kindergarten through college-age students
- **529 plan**
  - Helps parents save for the education of their children
  - No federal tax deduction, but earnings grow tax-free



# Changing Tax Strategies

- IRS usually modifies the tax form and filing procedures yearly
- Recent tax changes have included the following:
  - Employers now allow employees with health care flexible spending accounts to carry over up to \$500 of unused funds
  - Streamlined options are available for the home office deduction for small businesses
  - Qualified Business Income, also known as Section 199A, allows owners of pass-through businesses to claim a tax deduction worth up to 20% of the qualified business income



# Flat or VAT Tax?

- For years, politicians have used tax reform as a platform to run for office
- Options being proposed include the following:
  - A *flat tax* proposal, which would require all taxpayers (regardless of income level and type) to pay the same percentage, has been around for many years
    - Would result in an increase in overall tax for many people
  - A *value-added tax (VAT)* would add a tax to a product for each stage in the manufacturing process
    - Believed that higher-income individuals would pay higher taxes, as they are typically the larger consumers of goods



# Chapter Summary

## LO3.1: Identify the major tax types in our society.

- Tax planning can influence spending, saving, borrowing, and investing decisions.
- An awareness of income taxes, sales taxes, excise taxes, property taxes, estate taxes, inheritance taxes, gift taxes, and Social Security taxes is vital for successful financial planning.



# Chapter Summary

## LO3.2: Calculate taxable income and the amount owed for federal income tax.

- Taxable income is determined by subtracting adjustments to income and deductions from gross income.
- Your total tax liability is based on the published tax tables or tax schedules, less any tax credits.



# Chapter Summary

## LO3.3: Prepare a federal income tax return.

- The major sections of Form 1040 provide the basic framework for filing your federal income tax return.
- Main sources of tax assistance are the following:
  - IRS services and publications
  - Other publications
  - The Internet
  - Computer software
  - Professional tax preparers such as commercial tax services, enrolled agents, accountants, and attorneys



# Chapter Summary

## LO3.4: Select appropriate tax strategies for various life situations.

- You may reduce your tax burden through careful planning and making financial decisions related to consumer purchasing and the use of debt, investments, and retirement planning.