

# Lecture Notes

- 1) The Individual Income Tax Formula
  - a) Reporting taxable income
    - i) Income tax Form 1040 generally used to report taxable income.
    - ii) Refer to Exhibit 4-1 for Individual Tax Formula (but note that what is included on the tax return generally starts with gross income).
    - iii) Refer to Exhibit 4-2 for Form 1040. The exhibit provides the 2024 tax forms because the 2025 forms were not available at press time.
  - b) Realized income, exclusions, deferrals, and gross income
    - i) Realized income
      - (1) All-inclusive income concept
        - (a) Realized income is income generated in a transaction with a second party in which there is a measurable change in property rights between parties.
          - (i) Refer to Exhibit 4-3 for common income items (including character).
        - (b) Discuss concept of deferral versus exclusion.
          - (i) Refer to Exhibit 4-4 for common exclusions and deferrals.
    - c) Character of income
      - i) Determines rate at which income will be taxed for the year
      - ii) Tax-exempt
      - iii) Tax-deferred
      - iv) Ordinary
      - v) Capital
        - (1) Capital gain or loss from selling capital assets
        - (2) Capital asset
          - (a) Accounts receivable
          - (b) Inventory
          - (c) Property used in trade or business, including supplies
        - (3) Long-term capital gains
          - (a) Generally taxed at 0 percent, 15 percent, or 20 percent (net long-term gains in excess of net short-term losses). The IRS provides a separate schedule to that gives the break points for the different rates (see Appendix C). May mention, but don't discuss, 25 percent and 28 percent long-term capital gains.
          - (b) To be long-term, the taxpayer must have owned the asset for more than a year before selling. In determining the holding period, the day of disposition but not the day of acquisition is counted.
        - (4) Short-term capital gains
          - (a) Generally taxed at ordinary rates
        - (5) Net capital losses
          - (a) Deduct \$3,000 against ordinary income.

- (b) Carryover excess loss to future years (indefinite carryover).
  - vi) Qualified dividend
    - (1) Taxed at 0 percent, 15 percent, or 20 percent. Break points for the different rates are provided by the IRS (see Appendix C).
  - d) Deductions: Taxpayers are not allowed to deduct anything unless a specific tax provision allows them to do so.
    - i) Deductions for AGI
      - (1) Above the line
      - (2) Refer to Exhibit 4-5 for Partial Listing of Common *for* AGI Deductions.
    - ii) Deductions from AGI
      - (1) Below the line.
      - (2) Refer to Exhibit 4-6 for Primary Categories of Itemized Deductions.
      - (3) Refer to Exhibit 4-7 for Standard Deduction Amounts by Filing Status.
      - (4)
      - (5) Other from AGI deductions introduced by the OBBB. Like the QBI deduction, these are deductible whether or not the taxpayer itemizes deductions.
        - (a) Deduction for seniors.
        - (b) Deduction for qualified car loan interest.
        - (c) Deduction for qualified tip income.
        - (d) Deduction for qualified overtime compensation.
        - (e) Deduction for qualified business income (from AGI deduction but not itemized deduction). Equal to qualified business income  $\times$  20 percent.
  - e) Income tax calculation
    - i) Taxpayers generally calculate their income tax liability using either a tax table or a tax rate schedule, depending on their filing status and income level. This chapter covers the tax tables but does not deal directly with the tax tables. (You could pull up a tax table to show students.) The current tax rates range from 10 percent to 37 percent.
  - f) Other taxes
    - i) Alternative minimum tax and the self-employment tax (both covered in the Individual Income Tax Computation and Tax Credits chapter).
    - ii) The 3.8 percent net investment income tax (on unearned income) and the .9 percent additional Medicare tax (on earned income) are covered in the Individual Income Tax Computation and Tax Credits chapter.
  - g) Tax credits
    - i) Individual taxpayers may reduce their tax liabilities by tax credits to determine their total taxes payable.
  - h) Tax prepayments
    - i) Income taxes withheld from the taxpayer's salary or wages by the employer;
    - ii) Estimated tax payments the taxpayer makes for the year; and
    - iii) Taxes overpaid in the previous year that the taxpayer elects to apply as an estimated payment for the current year.
- 2) Dependents of the Taxpayer

- a) Dependency requirements
  - i) To qualify as a dependent of another, an individual:
    - (1) Must be a citizen of the United States or a resident of the United States, Canada, or Mexico.
    - (2) Must not file a joint return with the individual's spouse unless there is no tax liability on the couple's joint return and there would not have been any tax liability on either spouse's tax return if they had filed separately.
    - (3) Must be considered either a qualifying child of the taxpayer or a qualifying relative of the taxpayer.
  - ii) Qualifying child
    - (1) Relationship test
    - (2) Age test
    - (3) Residence test
    - (4) Support test
    - (5) Tiebreaking rules
  - iii) Qualifying Relative
    - (1) Relationship test
    - (2) Support test
    - (3) Gross income test
  - iv) Refer to Exhibit 4-8 for Summary of Dependency Requirements.
  - v) Refer to Appendix A of this chapter for flowchart to determine who qualifies as the taxpayer's dependent.

### 3) Filing Status

- a) Each year taxpayers determine their filing status according to their marital status at year-end and whether they have any dependents.
- b) Married filing jointly
  - i) Taxpayers must be legally married as of the last day of the year.
  - ii) When one spouse dies during the year, the surviving spouse is still considered to be married for tax purposes during the year of the spouse's death.
  - iii) Both spouses are ultimately responsible for paying the joint tax.
- c) Married filing separately
  - i) Each spouse files his or her own tax return.
  - ii) Generally, there is no tax advantage for filing separately.
  - iii) Each spouse is ultimately responsible for paying own tax.
  - iv) Generally, for nontax reasons, couples may choose to file separately.
    - (1) Limit liability for other spouse's taxes.
  - v) Requirements for married taxpayers to be treated as unmarried at end of year (also known as abandoned spouse rules)
    - Qualifies if:
      - (a) Taxpayer not legally separated from spouse.
      - (b) Taxpayer does not file joint return with spouse.

- (c) Spouse has not lived in taxpayer's home at all during last six months of year (excluding temporary absences due to illness, military, etc.).
    - (d) Taxpayer pays more than half the costs of maintaining a home that is principal place of abode for qualifying child.
    - (e) Taxpayer is eligible to file as head of household (see below)
  - d) Qualifying surviving spouse
    - i) Generally treated as married filing jointly.
    - ii) When the taxpayer's spouse dies, the surviving spouse can file as qualifying surviving spouse for two years after the year of the spouse's death if the surviving spouse remains unmarried and maintains a household for a dependent child.
  - e) Single
    - i) Unmarried taxpayers who do not qualify for head of household status file as single taxpayers.
  - f) Head of household
    - i) Unmarried or considered to be unmarried at year-end
    - ii) Not a qualifying surviving spouse
    - iii) Pay more than half the costs of maintaining home during year
    - iv) Lived in taxpayer's home with a qualifying person for more than half the year
      - (1) See exception for parents who qualify as taxpayer's dependents.
      - (2) Qualifying person
        - (a) Qualifying child
        - (b) Qualifying relative must live with taxpayer for more than half the year, be taxpayer's dependent, and must have qualifying family relationship.
        - (c) Parent, even if parent doesn't live with taxpayer, if parent qualifies as taxpayer's dependent.
        - (d) See Exhibit 4-9 for description of who is a qualifying person for purposes of the head of household test. See Appendix B to this chapter for a flowchart to use to determine who is a qualifying person for head of household filing status.
- 4) Summary of Income Tax Formula
    - a) Refer to Exhibit 4-10 for summary of the Halls' taxable income.
  - 5) Appendix A: Flowchart for determining who qualifies as a dependent.
  - 6) Appendix B: Flowchart for determining who is a qualifying person for head of household status.
  - 7) Appendix C: Flowchart for determining filing status.