Chapter 8

Lecture Notes

1) Regular Federal Income Tax Computation
   a) Tax rate schedules
      i) Schedule depends on filing status.
      ii) Each separate range of income subject to a different tax rate is referred to as a tax bracket.
      iii) Each filing status has its own tax rate schedules, which consist of tax brackets taxed at 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent.
      iv) The IRS provides tax tables that present the gross tax for various amounts of taxable income under $100,000 and filing status.
   b) Marriage penalty or benefit
      i) Marriage penalty (benefit) occurs because dual-earning spouses pay more (less) combined tax than if they each filed single.
      ii) Refer to Exhibit 8-1 for 2025 Marriage Penalty (Benefit): Two-Income vs. Single-Income Married Couple.
   c) Exceptions to the basic tax computation
      i) Preferential tax rates for capital gains and dividends
         (1) Net long-term capital gains and qualified dividends are generally taxed at 0 percent, 15 percent, or 20 percent.
         (2) The tax rate tables and tax rate schedules allow taxpayers to compute their tax on ordinary but not preferentially taxed income even though it is included in adjusted gross income (AGI) and taxable income.
         (3) Three steps to determine tax liability when income is subject to preferential rate:
            (a) Split taxable income into the portion that is subject to the preferential rate and the portion taxed at the ordinary rates.
            (b) Compute the tax separately on each type of income. Note that the income that is not taxed at the preferential rate is taxed at the ordinary tax rates using the tax rate schedule for the taxpayer’s filing status.
            (c) Add the tax on the income subject to the preferential tax rates and the tax on the income subject to the ordinary rates. This is the taxpayer’s regular tax liability. Note that rate at which preferentially taxed income would have been taxed if it were ordinary income is important.
      ii) Kiddie tax
         (1) Unearned income in excess of $2,700 is taxed at parent’s marginal tax rate if child is:
            (a) Under age 18 at year-end,
            (b) 18 at year-end but earned income does not exceed one-half of support, or
            (c) Over 18 and under 24 at year-end, full-time student, and earned income does not exceed half of support (excluding scholarships).
2) Alternative Minimum Tax (AMT)
   a) Implemented to ensure taxpayers pay some minimum level of income tax.
   b) Alternative minimum tax formula
      i) Start with taxable income and make adjustments to determine alternative minimum taxable income.
      ii) Refer to Exhibit 8-2 for Formula for Computing the Alternative Minimum Tax.
      iii) Alternative minimum taxable income (AMTI)
         (1) Adjustments

(a) Add the standard deduction (if deducted for regular tax purposes) back to regular taxable income in determining AMTI.
(b) The major itemized deductions that are deductible for both regular tax and AMT purposes using the same limitations for both systems are:
(i) Charitable contributions.
(ii) Home mortgage interest expenses.
(iii) Gambling losses.
(c) Some deductions are deductible for regular tax and AMT purposes but have different limitations for each system, e.g., investment interest expense.
(d) Refer to Exhibit 8-3 for Common AMT Adjustments and Exhibit 8-4 for Alternative Minimum Tax—Individuals.

iv) AMT exemption
(1) Allows taxpayers to determine their alternative tax base to deduct an AMT exemption.
(2) The exemption is phased out (reduced) by 25 cents for every dollar the AMTI exceeds the threshold amount.
(3) Refer to Exhibit 8-5 for 2025 AMT Exemptions and phase-out thresholds.

v) Tentative minimum tax and AMT computation
(1) AMT rate schedule consists of the following two brackets:
(a) 26 percent on first $239,100 (indexed for inflation annually) of AMT base for all taxpayers other than married taxpayers filing separately ($119,550, indexed for inflation annually, for married taxpayers filing separately).
(b) 28 percent on AMT base in excess of $239,100 (indexed for inflation annually) for all taxpayers other than married taxpayers filing separately ($119,550, indexed for inflation annually, for married taxpayers filing separately).
(2) AMT = tentative minimum tax − regular tax liability
(3) Net long-term capital gains and qualifying dividends taxed at same preferential rates used for regular tax purposes (generally 0 percent, 15 percent, or 20 percent).

3) Additional Taxes
i) Net investment income tax
(1) 3.8 percent tax imposed on lesser of:
(a) Net investment income or
(b) Excess of modified AGI over $250,000 (married filing jointly and surviving spouses), $125,000 (married filing separately), and $200,000 (all others).

b) Employment and self-employment taxes
i) Employee FICA taxes payable
(1) Social Security tax
(a) Tax rate is 6.2 percent rate on wage base.
(b) 2025 wage base limit is $176,100.
(2) Medicare tax
(a) Tax rate is 1.45 percent rate on wage base.
(3) Additional Medicare tax
(a) Tax rate is .9 percent rate on salary or wages in excess of $200,000 ($125,000 for married filing separately; $250,000 of combined salary or wages for married filing jointly).
(4) Employer FICA taxes payable
(a) Social Security tax
(i) Tax rate is 6.2 percent rate on wage base.
(ii) 2025 wage base limit is $176,100.
(b) Medicare tax
(i) 1.45 percent of employee salary of wages.

ii) Self-employment taxes

(1) The process for determining the taxpayer's self-employment taxes (and additional Medicare tax) payable on self-employment earnings requires the following steps:
   (a) Step 1: Compute taxpayer's net income from self-employment activities that is subject to self-employment taxes. This is generally the taxpayer's net income from Schedule C of Form 1040.
   (b) Step 2: Compute net earnings from self-employment = Step 1 × 92.35 percent.
   (c) Step 3: Compute the Social Security tax. The Social Security tax component of the self-employment tax equals 12.4 percent [the combined Social Security tax rate for employer and employee (6.2% + 6.2% = 12.4%)] multiplied by the lesser of:
      (i) the taxpayer's net earnings from self-employment (from Step 2) or
      (ii) $176,100 (the maximum tax base for the Social Security tax in 2025).
   (d) Step 4: Compute the Medicare tax. The Medicare tax component of the self-employment tax equals 2.9 percent [the combined Medicare tax rate for employer and employee (1.45% + 1.45% = 2.9%)] multiplied by the net earnings from self-employment (from Step 2).
   (e) Step 5: Compute the additional Medicare tax. The additional Medicare tax due on net self-employment earnings equals .9 percent multiplied by the greater of:
      (i) zero or
      (ii) net earnings from self-employment (from Step 2) less $200,000 ($125,000 for married filing separately; $250,000 for married filing jointly). The additional Medicare tax is considered an "employee" tax (and not a "self-employment" tax).

(2) When a taxpayer receives both employee compensation and self-employment earnings, the calculation of the taxpayer's FICA taxes on self-employment earnings in these settings can be determined as follows:
   (a) Social Security Tax:
      (i) Step 1: Determine the limit on the Social Security portion of the self-employment tax base by subtracting the employee compensation from the Social Security wage base ($176,100 in 2025) (not below $0).
      (ii) Step 2: Determine the net earnings from self-employment (self-employment earnings times 92.35 percent).
      (iii) Step 3: Multiply the lesser of Steps (1) and (2) by 12.4 percent. This is the amount of Social Security taxes due on the self-employment income.
   (b) Medicare Tax:
      (i) Step 4: Multiply the amount from Step (2) by 2.9 percent, the combined Medicare tax rate for employer and employee.
   (c) Additional Medicare Tax:
      (i) Step 5: Add the amount from Step (2) and the taxpayer's compensation. If married filing jointly, also add the spouse's compensation and net earnings from self-employment (spouse's self-employment earnings times 92.35 percent).
      (ii) Step 6: Multiply the greater of [(a) zero or (b) the amount from Step (5) minus $200,000 ($125,000 for married filing separately; $250,000 for married filing jointly)] by .9 percent.
      (iii) Step 7: Take the amount from Step 6 and subtract the amount of the additional Medicare tax withheld by the taxpayer's employer (and his or her spouse's employer if married filing jointly). This is the additional Medicare tax due on the self-employment income.

iii) Employee versus self-employed (independent contractor)
(1) A few of the factors suggesting independent contractor rather than employee status include the contractor's ability to:
   (a) Set own working hours
   (b) Work part-time

(c) Work for more than one firm
(d) Realize either a profit or loss from the activities
(e) Perform work somewhere other than on employer's premises
(f) Work without frequent oversight
(g) Others in published IRS guidance

(2) Employee versus independent contractor comparison
(a) The two primary tax differences between independent contractors and employees relate to:
(i) The amount of their FICA taxes payable and
(ii) The deductibility of their business expenses (and possibly the qualified business income deduction).
(b) The key facts: Employee vs. independent contractor
(i) Employees
1. Less control over how, when, and where to perform duties.
2. Pay 6.2 percent Social Security tax subject to limit.
3. Pay 1.45 percent Medicare tax (no limit).
4. Pay additional Medicare tax of .9 percent wage base in excess of $200,000 ($125,000 for married filing separately; $250,000 married filing jointly).
5. Unreimbursed employee business expenses are not deductible.

(ii) Independent contractors
1. More control over how, when, and where to perform duties.
2. Report income and expenses on Form 1040, Schedule C.
a. Expenses are for AGI deductions.
3. Pay 12.4 percent Social Security tax subject to limit.
4. Pay 2.9 percent Medicare tax (no limit).
5. Pay additional Medicare tax of .9 percent of net self-employment earnings in excess of $200,000 ($125,000 for married filing separately; $250,000 married filing jointly).
6. Self-employment tax base is 92.35 percent of net self-employment income.
7. Deduct employer portion of self-employment taxes paid for AGI.

4) Tax Credits
a) Nonrefundable personal credits
i) Child tax credit
(1) $2,200 credit for each qualifying child under age 17 at the end of the year and who is claimed as the taxpayer's dependent.
(2) $500 credit for other qualifying dependents.
(3) The child tax credit is partially refundable. The $500 child tax credit is nonrefundable.
(4) Credit is phased out for taxpayers with AGI above threshold.
(a) Lose $50 for every $1,000 or portion thereof by which AGI exceeds threshold.
(5) See Exhibit 8-8 for Child Tax Credit Phase-Out Threshold (based on filing status).
(6) Determining their allowable child tax credit after the phase-out by using the following four steps:
(a) Step 1: Determine the excess AGI by subtracting the threshold amount from the taxpayer's AGI.
(b) Step 2: Divide the excess AGI from Step (1) by 1,000 and round up to the next whole number.
(c) Step 3: Multiply the amount from Step (2) by $50. This is the amount of the total credit that is phased out or disallowed.
(d) Step 4: Subtract the amount from Step (3) from the total credit before phase-out (limited to $0) to determine the allowable child tax credit.

ii) Child and dependent care credit

(1) Credit to help taxpayers who work or seek work when they must provide care for dependents.
(2) Credit is a nonrefundable credit.
(3) Credit is based on maximum qualifying expenditures multiplied by the rate based on AGI.
(4) Maximum expenditures are $3,000 for one qualifying person or $6,000 for two or more qualifying persons.
  (a) Highest rate (for low AGI taxpayers) is 35 percent for the lowest AGI taxpayers and 20 percent for the highest.
(5) Refer to Exhibit 8-9 for Child and Dependent Care Credit Percentage.

iii) Education credits
  (1) American opportunity credit
    (a) Qualifying expenses include tuition, fees, and course materials (cost of books and other materials) needed for courses of instruction at an eligible educational institution.
    (b) Maximum credit of $2,500 per student calculated as percentage of maximum of $4,000 qualifying expenses (100 percent of first $2,000 plus 25 percent of next $2,000).
    (c) Subject to phase-out for taxpayers with AGI in excess of $80,000 ($160,000 MFJ).
    (d) 40 percent of credit is refundable.
  (2) Lifetime learning credit
    (a) Qualifying expenses include costs at a qualifying institution associated with acquiring or improving job skills.
    (b) Maximum credit of $2,000 per taxpayer calculated as percentage of maximum of $10,000 in annual expenses.
    (c) Subject to phase-out for taxpayers with AGI in excess of $80,000 ($160,000 MFJ).

b) Refundable personal credits
  i) Earned income credit
    (1) Designed to offset employment taxes for lower-income taxpayers.
    (2) Available to qualified individuals with earned income
      (a) Individual with at least one qualifying child.
      (b) Individual with no qualifying child who lives in United States for more than half the year, is at least 25 years of age but younger than 65, and is not the dependent of another taxpayer.
    (3) Refer to Exhibit 8-10 for 2025 Earned Income Credit Table.
  ii) Other refundable personal credits
    (1) Portion of the child tax credit
    (2) Portion of the American opportunity tax credit
    (3) Excess FICA withholdings
    (4) Taxes withheld on wages and estimated tax payments

c) Business tax credits
  i) They are designed to provide incentives for taxpayers to hire certain types of individuals or to participate in certain business activities.
  ii) When business credits other than the foreign tax credit exceed the taxpayer's gross tax for the year, the credits are carried back one year and forward 20 years to use in years when the taxpayer has sufficient gross tax liability to use the credits.
  iii) Foreign tax credit
    (1) U.S. citizens must pay U.S. tax on their worldwide income. However, when they generate some or all of their income in other countries, they generally are required to pay income taxes to the foreign country where they earned their income.

      (2) Without some form of tax relief, taxpayers earning income overseas would be double-taxed on this income.
      (3) The foreign tax credit helps reduce the double tax taxpayers may face when they pay income taxes on foreign-earned income to the United States and to foreign countries.
  d) Tax credit summary
    i) Refer to Exhibit 8-11 for Summary of Selected Tax Credits.
  e) Credit application sequence
    i) Nonrefundable personal first, then business, then refundable personal.
    ii) Refer to Exhibit 8-12 for Credit Application.
5) Taxpayer Prepayments and Filing Requirements
  a) Prepayments
    i) Taxpayers prepay their tax via withholding from salary or through periodic estimated tax payments during the tax year.
    ii) Estimated tax payments are required only if withholdings are insufficient to meet the taxpayer's tax liability.
    iii) For calendar-year taxpayers, estimated tax payments are due on April 15, June 15, and September 15 of the current year and January 15 of the following year. If the due date falls on a Saturday, Sunday, or holiday, it is automatically extended to the next day that is not a Saturday, Sunday, or holiday.
    iv) Underpayment penalties
      (1) The tax laws provide some safe-harbor provisions under which they can avoid underpayment penalties if their withholdings and estimated tax payments equal or exceed one of the following two safe harbors:
        (a) 90 percent of their current tax liability or
        (b) 100 percent of their previous-year tax liability (110 percent for individuals with AGI greater than $150,000).
      (2) The underpayment penalty is determined by multiplying the federal short-term interest rate plus 3 percentage points by the amount of tax underpayment per quarter.
  b) Filing requirements
    i) Individual taxpayers are required to file a tax return only if their gross income exceeds certain thresholds, which vary based on the taxpayer's filing status and age.
    ii) Individual tax returns are due on April 15 for calendar-year individuals. If the due date falls on a Saturday, Sunday, or holiday, it is automatically extended to the next day that is not a Saturday, Sunday, or holiday.
    iii) Taxpayers unable to file a tax return by the original due date can request (by that same deadline) a six-month extension to file, which is granted automatically by the IRS. The extension gives the taxpayer additional time to file the tax return, but it does not extend the due date for paying the tax.
    iv) Late filing penalty
      (1) Imposed on taxpayers that do not file tax return by the required date (the original due date plus extension).
      (2) Penalty is 5 percent of the amount of tax owed for each month (or fraction of a month) that the tax return is late, with a maximum penalty of 25 percent.
      (3) For fraudulent failure to file, the penalty is 15 percent of the amount of tax owed per month, with a maximum penalty of 75 percent.
    v) Late payment penalty
      (1) Imposed if taxpayer fails to pay entire balance of tax owed by the original due date of return.
        (a) .5 percent of the amount of tax owed each month (or fraction of a month) that the tax is not paid.

(2) If the late filing penalty and late payment penalty both apply in the same month, the late filing penalty of 5 percent for the month (and its corresponding maximum penalty of 25 percent) is reduced by the .5 percent late payment penalty for the month. If the fraudulent late filing penalty applies, a similar reduction applies to the 15 percent monthly penalty and maximum 75 percent penalty.

(3) In contrast, the late payment penalty of .5 percent and its corresponding maximum penalty of 25 percent are not reduced by the late filing penalty when they both apply. Thus, when both the late filing penalty and late payment penalty apply, the combined total penalty can be as high as 47.5 percent (22.5 percent for late filing and 25 percent for late payment) when both penalties apply for their maximum periods. Similarly, when both the fraudulent late filing penalty and late payment apply, the combined total penalty can be as high as 97.5 percent (72.5 percent for fraudulent late filing and 25 percent for late payment).