

**PART 1:
FINANCIAL PLANNING**

Chapter 4

**Tax Planning and
Strategies**

Learning Objectives

- Explain how the present U.S. income tax system came into being.
- Identify and understand the major tax features that affect all taxpayers.
- Describe the other non-income-based taxes that you must pay.
- Understand what is taxable income and how taxes are determined.
- Choose the tax form that's right for you.
- Calculate your income taxes.

Taxes Then, Taxes Now

- Tax Freedom Day – when the average American has earned enough to pay federal, state, and local taxes for that year.
 - In 1950 Tax Freedom Day was March 31st
 - In 2000 Tax Freedom Day was May 3rd
 - In 2005 Tax Freedom Day was April 17th
- Taxes are the single largest annual expenditure for most families.

The Federal Income Tax Structure

- Present tax structure is progressive or graduated, meaning increased income is taxed at increasing rates.
- Tax brackets differentiate income levels.
- This system is based on the idea that those who earn more can afford to pay a higher percentage of their income in taxes.

The Federal Income Tax Structure

- Not all income is taxed.
 - Some income is tax-free because of personal exemptions.
 - Some income is shielded by itemized or standard deductions.
- Taxable income is a function of adjusted gross income (AGI), deductions, and exemptions.

The Federal Income Tax Structure

- Assume you are in the 15% tax bracket. Does that mean you pay 15% of your taxable income in taxes?
- No. Taxes are graduated, so income is taxed at increasing rates. The last dollar earned is taxed at 15%. Earlier income was taxed at the lower rate.

Marginal Versus Average Taxes

Average Tax Rate

- Relates taxes to taxable or overall income. This is the average amount of your total income taken away in taxes.

Marginal Tax Rate

- Looks at the percent of the last dollar earned that goes to pay taxes. This is also known as the marginal tax bracket.

Marginal Versus Average Taxes

- Marginal tax rate is important when investing in a tax-deferred retirement plan.
- Since the government allows tax deductions for contributions to retirement plans, a \$1000 contribution, if you are in the 15% tax bracket, lowers your taxes by \$150.
- The reduction allows you to invest the entire \$1000 rather than only \$850 ($\$1000 - \150 in taxes).

Effective Marginal Tax Rate

- Federal income taxes are not the only income-based taxes you pay. You pay:
 - State income taxes
 - City or local taxes
 - Social security taxes
- As a result of these taxes, your effective marginal tax rate – the rate you pay when all income taxes are combined – is greater than the marginal tax rate on federal income taxes.

Capital Gains and Dividend Income

- A “capital gain” occurs when a capital asset is sold for a profit.
 - The tax paid on the gain is a “capital gains tax.”
 - Assets held for 12 months or more qualify as a long-term capital gain, taxed at a lower rate.
- A “capital loss” occurs when a capital asset is sold for a loss.
 - Capital losses can offset capital gains.

Capital Gains and Dividend Income

- The tax laws provide a lower tax rate on both the long-term capital gains and on dividends.
- Long-term capital gains tax applies to profits from the sale of stocks and bonds, it does not apply to collectibles.
- You don't pay the capital gains tax until the asset is sold.

Long-Term Capital Gains on Homes

- The Taxpayer Relief Act of 1997 effectively eliminates capital gains taxes on a house sale for most homeowners.
- It exempts gains up to \$500,000 for couples filing jointly.
 - Home must be the principal residence.
 - Must have been occupied for 2 of the past 5 years.

Filing Status

Single

- Have no dependent children.

Married Filing Jointly and Surviving Spouses

- Combine income and deductions into a single return.

Married Filing Separately

- Used if couples are separated or getting divorced.

Head of Household

- Unmarried and living with at least one child or relative.

Cost of Living Increases in Tax Brackets, Exemptions, and Deductions

- Since 1985, tax brackets have changed annually to reflect changes in the cost of living (inflation).
- Standard deductions and personal exemptions are increased to reflect inflation.
- This ensures that tax payments don't increase just because of a cost of living increase in wages.
- The increase caused by inflation is called "bracket creep."

Paying Your Income Taxes

- Most taxes are collected on a pay-as-you-go basis. Nearly all individual income taxes are collected through withholding from wages.
 - These withholdings include social security, state, and local taxes.
 - Taxes are also collected through quarterly estimated taxes sent to the IRS, payments with tax return, and withholdings from stock dividends, retirement funds, and prize winnings.

Paying Your Income Taxes

- You have some control over how much is deducted for taxes from your wages.
 - Withholdings are determined by income level and information on W-4 form.

Other Taxes

Income-Based Taxes

- Social Security or FICA
- State and local income taxes

Non-Income-Based Taxes

- Excise taxes – “sin taxes”
- Property taxes
- Gift and estate taxes

Calculating Your Taxes

- If your income is more than \$17,800 you must file a tax return.
- Figure 4.1 lists the rules for who must file a return.
 - Dependents with income over \$4850 from a job must file a return.
 - Those with unearned income, from investments, of \$800 must file a return.

Calculating Your Taxes

Step 1: Determining Gross or Total Income

- Total or gross income is the sum of all taxable income from all sources.
 - Active income – from wages, salaries or tips
 - Portfolio or investment income – securities
 - Passive income – activities in which the taxpayer does not actively participate

Calculating Your Taxes

Step 2: Calculating Adjusted Gross Income (AGI)

- Adjusted gross income (AGI) is gross income less allowable deductions.
- Adjustments include:
 - Payments set aside for retirement
 - Some moving expenses
 - Alimony payments

Calculating Your Taxes

Step 3: Subtracting Deductions

- Choose between standard deduction or itemizing.
- Standard deduction is the government's best estimate of what the average person would deduct if itemizing.

Calculating Your Taxes

Step 3: Subtracting Deductions

- Itemize deductions by listing all those allowable:
 - Medical and dental expenses
 - Tax expenses
 - Home mortgage and investment interest payments
 - Gifts to charity
 - Casualty and theft loss
 - Miscellaneous deductions

Calculating Your Taxes

Step 4: Claiming Your Exemptions

- An exemption is a deduction for each person supported by the income on a tax return.
- In 2004, each exemption lowered taxable income by \$3100.
- Exemptions can be personal or dependency.
- Once your AGI reaches a certain level, the value of the exemption is reduced.

Calculating Your Taxes

Step 5: Calculating Your Taxable Income, and From That, Calculating Your Base Income

- Taxable income = AGI 2 (deductions and exemptions).
- Once taxable income is determined, the income tax can be found in the federal income tax booklet.
 - Taxable income above \$100,000 determined by rate schedules.
- Alternative minimum tax (ATM) ensures that everyone pays taxes.

Calculating Your Taxes

Step 6: Subtract Your Credits and Determine Your Taxes Due

- Tax credits offset taxes in a direct manner – not merely reducing taxable income but offsetting taxes.
 - Child Credit
 - The Hope Scholarship Tax Credit and the Lifetime Learning Credit
 - Other Tax Credits
 - Child and dependent care credit
 - Earned income credit
 - Adoption credit

Other Filing Considerations

- Choosing a tax form
 - 1040EZ – no dependents, income under \$100,000, no itemizing.
 - 1040A – the original easy form, \$100,000 total taxable income, allows dependents, and IRA contributions.

Other Filing Considerations

- Choosing a tax form
 - 1040 – the “long form,” allows for itemized deductions and adjustments to income.
 - A schedule is an attachment to this form providing information on income and expenses listed on 1040.

Other Filing Considerations

- Electronic Filing
- Over half of all taxpayers file electronically
- Benefits include:
 - Faster refunds
 - More accurate returns
 - Quick electronic confirmation
 - Easy payment options

Filing Late and Amended Returns

- File Late – Form 4868 - request an extension if unable to file by April 15th and include estimated tax payment.
 - If no enclosed check, then charged interest on taxes.
- Amended Return - Form 1040X – file within 3 years of original tax date.
 - Amend the state and local forms as well.

Being Audited

- IRS audits over 1 million taxpayers annually.
- Why an audit?
 - Randomly selected
 - Audited in the past
 - High income
 - Itemized deductions
 - Self-employment income
- Keep good records and appeal audit outcome if necessary.

Help in Preparing Taxes

- Handle taxes by yourself.
 - Use IRS booklets, toll-free hot line, or walk in service.
- Use self-help publications and computer programs.
- Hire a tax specialist
 - National affiliations
 - Independent tax specialists