**Chapter One**

**The Individual Income Tax Return**

**Learning Objective 1.1 History and Objectives of the Tax System**

The US income tax was authorized by the Sixteenth Amendment to the Constitution on March 1, 1913. Prior to its adoption, the US government had levied various income taxes for limited periods of time (Civil War). The finding by the U.S. Supreme Court that the income tax law enacted in 1894 was unconstitutional led to the adoption of the 16th amendment in 1913…just in time to assist in U.S. war efforts during WWI. Since this amendment was adopted, the constitutionality of taxing income has not again been before federal courts.

Income taxes do more than provide revenue to operate government. Income taxes also serve as a tool of economic and social policy. Tax credits, exemptions, and deductions reward the individual taxpayer for making a particular choice. The choice being rewarded/promoted should positively affect public good.

Some tax provisions meet both economic and social goals. If a gain on the sale of a personal residence is excluded from taxable income, it helps a family more easily afford a new home and also ensures that the U.S. has a mobile workforce (employees are not penalized for moving).

**Learning Objective 1.2 Reporting and Taxable Entities**

Under US tax law there are five basic taxable or reporting entities: individuals, corporations, partnerships, estates, and trusts.

Taxable income for the individual generally includes wages, salaries, self-employment earnings, rent, interest, and dividends. Individual taxpayers file a Form 1040EZ, Form 1040A, or Form 1040.

Form 1040-EZ’s may be filed if the individual taxpayer:

* Is single or married filing a joint return
* Is not age 65 or older and/or blind
* Is not claiming any dependents
* Has taxable income of less than $100,000
* Includes in income only wages, salaries, tips, taxable fellowship grants or scholarships, unemployment compensation, and $1,500 or less taxable interest income
* Has not claimed any credits other than the earned income credit

Form 1040A is generally filed if the individual taxpayer is not self-employed and does not benefit from itemizing his/her deductions. Form 1040, referred to as “the long form,” is used by all individual taxpayers who must file a tax return and do not qualify to use the 1040EZ or 1040A. Corporations are subject to income tax and report the tax on a Form 1120. A partnership is not a taxable entity; instead it is a reporting entity. The partnership reports the income or loss on a Form 1065. The partners pay the tax on the income on their individual income tax form.

**Major Tax Forms and Schedules**

|  |  |
| --- | --- |
| 1040EZ | Individual return - single and joint filers with no dependents |
| 1040A | Individual return – short form |
| 1040 | Individual return – long form |
| 1040X | Amended individual return |
| Schedule A | Itemized deductions |
| Schedule B | Interest and dividend income |
| Schedule C | Profit or loss from business or profession |
| Schedule D | Capital gains and losses |
| Schedule E | Supplemental income or loss (rent, royalty and pass-through from Forms 1065, 1120S and 1041) |
| Schedule F | Farm and ranch income |
| 1120 | Corporate tax return, long form |
| 1120S | S Corporation tax return |
| 1065 | Partnership information return |
| Schedule K 1 | Allocation of partnership results |
| 1041 | Fiduciary (estates & trusts) tax return |

**Learning Objective 1.3 The Tax Formula for Individuals**

Gross Income

- Deductions for Adjusted Gross Income

= Adjusted Gross Income (AGI)

- Greater of Itemized Deductions or the Standard Deduction

- Exemptions

= Taxable Income

x Tax Rate

= Gross Tax Liability

- Tax Credits and Prepayments

= Tax Due or Refund

Gross income includes all income unless tax law provides for a specific exclusion. Deductions for adjusted gross income include business expenses, certain reimbursed employee business expenses paid under an accountable plan, alimony payments, moving expenses, student loan interest, the penalty on early withdrawal from savings, contributions to qualified retirement plans, and if extended in 2014, certain educator expenses and a deduction for tuition and fees. Adjusted gross income (AGI) is the basis for limits for some deductions like medical expenses. Itemized deductions include medical expenses, interest expense, charitable contributions, and casualty losses. Note: Taxpayers should itemize deductions only if the total amount exceeds the standard deduction amount. Exemptions are worth $3,950 for 2014. A taxpayer’s gross tax liability is obtained from a tax table or a tax schedule. Tax credits and prepayments are subtracted from gross tax liability to calculate the net tax due to the government or the refund due the taxpayer.

**Standard Deduction Table**

|  |  |
| --- | --- |
| **Filing Status** | **2014 Standard Deduction** |
| Single | $6,200 |
| Married, filing jointly | $12,400 |
| Married, filing separately | $6,200 |
| Head of household | $9,100 |
| Qualifying widow(er) | $12,400 |

Taxpayers who are 65 years or age or older or blind are entitled to an additional standard deduction amount as explained in LO 1.7.

**Learning Objective 1.4 Who Must File**

You also must file if you owe any special taxes, such as social security and Medicare tax on tips, alternative minimum tax, tax on an Individual Retirement Arrangement, or recapture of taxes or recapture of the first-time homebuyer credit. Taxpayers who had net earnings of $400 or more form self-employment must file. You must file if you had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes. A taxpayer otherwise not required to file a return, must do so to receive an income tax refund.

**Learning Objective 1.5 Filing Status and Tax Computation**

Tax law has five different filing statuses: single, married filing jointly, married filing separately, head of household and qualified widow(er). (See table below). Each filing status has a separate tax schedule. A tax rate schedule is used only if the taxpayer’s taxable income is over $100,000 or if the taxpayer is using a special method to determine his/her tax liability. Taxpayers who have taxable income less than $100,000 must use the tax table rather than the schedule.

|  |  |
| --- | --- |
| **Filing Status** | **Tax Rate Schedule** |
| Single | Tax Rate Schedule X |
| Married, filing jointly | Tax Rate Schedule Y-1 |
| Married, filing separately | Tax Rate Schedule Y-2 |
| Head of Household | Tax Rate Schedule Z |
| Qualifying Widower | Tax Rate Schedule Y-1 |

For 2014, there are seven income tax brackets: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent and 39.6 percent. Even though these brackets are listed on the Income Tax Schedule, they are in effect the tax brackets for taxpayers of all income, even those who use the Tax Table.

The tax rates applicable to long-term capital gains currently range from 0 percent to 31.8 percent depending on the taxpayer’s tax bracket and the kind of capital asset. The tax rates for qualifying dividends range from 0 percent to 23.8 percent in 2014.

**Learning Objective 1.6 Personal and Dependency Exemptions**

Taxpayers are allowed two types of exemptions: personal (for themselves) and dependency (for their dependents). Almost every taxpayer and spouse is entitled to one personal exemption.

An exemption may be claimed for each person other than the taxpayer or spouse who qualifies as a dependent. A dependent is an individual who meets the tests discussed below for either a qualifying child or qualifying relative.

In order for a child to be considered a dependent, the following tests must be met:

Relationship Test

The child must be the taxpayer’s child, stepchild, adopted child or the taxpayer’s brother or sister, half brother or sister or stepsibling or a descendant of any of these. The child must be younger than the person claiming him or her unless the child is permanently disabled.

Domicile Test

The child must have the same principal place of abode as the taxpayer for more than six months of the tax year.

Age Test

The child must be under age 19 or a full-time college student under the age of 24. A full-time student is defined as enrolled for at least five months in a tax year.

Joint Return Test

The child must not file a joint return with his or her spouse.

Citizenship Test

The dependent must be a United States citizen, a resident of the United States, Canada or Mexico or an alien child adopted and living with a United States citizen.

Self-Support Test

The taxpayer must provide more than one-half of the child’s support. Support includes expenditures for food, lodging, clothes, medical and dental care, and education.

In order to qualify as a relative, the following tests must be met:

Relationship or Member of Household Test

The dependent must be related to the taxpayer or spouse or be a member of the household. The list of relatives includes parents, grandparents, children, grandchildren, siblings, aunts and uncles by blood, nephews and nieces, “in-laws” and adopted children. Any person who lived in the home as a member of the household for the entire year meets the relationship test.

Gross Income Test

A dependent must receive less than $3,950 in gross income to qualify.

Support Test

A dependent must receive over half of his/her support from the claiming taxpayer or spouse.

Joint Return Test

The dependent must not file a tax return with his/her spouse unless it is only to claim a refund of taxes due.

Citizenship Test

The dependent must be a US citizen, a resident of US, Canada, or Mexico, or an alien child adopted by and living with a US citizen in a foreign country.

**Learning Objective 1.7 The Standard Deduction**

The standard deduction was put into tax law to aid taxpayers with few itemized deductions. Even so, if you may not use the standard deduction you must itemize if 1) you are married and your spouse filing separately itemizes, 2) you are a non-resident alien, or 3) you are an individual filing a short-period return resulting from a change in accounting period. If a taxpayer has less gross income than his/her standard deduction, he/she has no taxable income.

|  |  |
| --- | --- |
| **Filing Status** | **2014 Standard Deduction** |
| Single | $6,200 |
| Married, filing jointly | $12,400 |
| Married, filing separately | $6,200 |
| Head of household | $9,100 |
| Qualifying widow(er) | $12,400 |

Taxpayers who are age 65 or older or blind are entitled to an additional standard deduction (2014: $1,550 for unmarried; $1,200 for married taxpayers and surviving spouses). If the taxpayer is both 65 and blind, s/he is entitled to two additional standard amounts. These additional deduction amounts extend to the taxpayer’s spouse but not to dependents.

The total standard deduction for a dependent may not exceed the greatest of $1,000 or the sum of $350 plus dependent’s earned income up to the basic standard deduction amount plus any additional standard deduction for old age or blindness. A dependent cannot claim a personal exemption on his or her tax return.

**Learning Objective 1.8 A Brief Overview of Capital Gains and Losses**

When taxpayers sell assets, the resulting transaction creates a gain or a loss. The basic formula for calculating a gain or loss is:

Gain (or loss) = Amount realized – Adjusted basis

Chapter 8 of the text explores gains and losses in more detail. It is more important for this chapter to know the basic definition of capital gains or losses and ordinary gains or losses.

**Learning Objective 1.9 Special Rules for High-Income Taxpayers**

The Affordable Care Act (ACA) and the American Taxpayer Relief Act (ATRA) increased taxes on high-income taxpayers in 2013.

Affordable Care Act (ACA) imposes two new taxes; a 3.8 percent Medicare Tax on net investment income when MAGI exceeds $200,000 – single and $250,000 – MFJ ($125,000-MFS) and a 0.9 percent Medicare Surtax on earned income (LO 9.9).

* Investment income includes interest and dividends, royalties, annuities, net rental income (with some exceptions), passive activities and most gains on sale of capital and other assets. It does not include exempt interest, excluded gain on sale of personal residence, distributions from retirement plans and IRAs, or wages and self-employment income subject to the new 0.9 percent tax.
* Investment expenses include allocable state income tax, investment interest and allocable investment expenses in excess of 2 percent of AGI but does not include $3,000 net capital loss deduction or net operating losses.

American Taxpayer Relief Act (ATRA) increased the top tax rate to 39.6 percent when taxable income is above $406,750 – single, $432,200 – HOH and $457,600 – MFJ. The Act also increased the top rate for Qualified Dividends and Capital Gains to 20 percent for taxpayers in the new 39.6 percent tax bracket.

**Learning Objective 1.10 Tax and the Internet**

The Internal Revenue Service has a great site where taxpayers can obtain forms, publications, regulations and view various tax-related articles. The IRS site, [www.irs.gov](http://www.irs.gov/), allows taxpayers to communicate with the IRS via email. The IRS also offers IRS2GO – a mobile phone app.

**Learning Objective 1.11 Electric Filing (e-filing)**

Electronic filing (e-filing) is the process of transmitting federal income tax returns to the IRS Service Center using a computer with a modem or Internet access. Two methods of e-filing exist. The first method is e-filing using a computer and tax preparation software to transmit information to the IRS. The second method is to employ professional tax preparer to send the information.