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**Fundamentals of**

**Federal Income Taxation**

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## ABOUT GREENE CONSULTING ASSOCIATES, LLC

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## Introduction

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| The goal of this course is to better equip you to help your clients make tax-informed investment and planning decisions.  Individual income taxes are computed and filed on Form 1040 (or on the simpler 1040A or 1040EZ forms for eligible taxpayers). The 1040 and its associated schedules can be quite intimidating.  Yet familiarity with the form and how income taxes are computed can provide invaluable understanding regarding the tax implications of decisions you may make personally or advice you may offer when working with wealthy clients. As we discuss each of the primary components of the tax return, we will also highlight some of the issues that are most relevant to financial services professionals who work with high net worth clients.  Cutting through the complexity, this course will provide you with a framework for understanding the basic components of Form 1040 and how taxes are computed.   |  | | --- | | ***Compliance Alert***  Remember, you must neither perform income tax calculations nor prepare income tax returns for your clients; that should be left to a CPA, CFP® professional, or other qualified tax advisor. Your role is to raise planning awareness for follow up with a professional tax advisor. | | 2014 Form 1040 Page 2 |

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| Objectives - By studying this course, you will learn about:   * The basic formula for calculating income taxes * The layout and content of Form 1040 * Key tax terminology * Above-the-line and below-the-line adjustments * How capital gains and losses are recognized and taxed * Specific tax rules associated with certain types of assets or transactions, e.g., worthless securities, options, wash sales, and annuities. * Standard and itemized deductions * AMT tax preference items * Various tax credits * Schedules A, Schedule D, and Form 6251 |

Form 1040

Throughout this course, it will be helpful for you to have a printed copy of Form 1040 that you can refer to. You can obtain and print a copy of Form 1040 by clicking [IRS Forms and Publications](https://apps.irs.gov/app/picklist/list/formsPublications.html) (search for *1040*).

## Basic Tax Formula

Before looking at Form 1040, let’s first look at the ***basic tax formula*** that it represents. This ***basic tax formula*** serves as a general map of the entire form. It also serves as a roadmap for this course because we shall be discussing each segment of this formula throughout the remainder of this course.

Take a few minutes to become thoroughly familiar with this formula, as it is your key to understanding the entire process. **Click each highlighted term to learn more.**

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| **Basic Tax Formula**  Gross Income  Less adjustments for Adjusted Gross Income (AGI)  Adjusted Gross Income (AGI)  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  Taxable Income  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  Tentative Tax  Less tax credits  Plus other taxes  Equals Income Tax Liability |

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| **Gross Income**  The basic income tax formula begins with Gross Income***. Gross Income*** is based on Internal Revenue Code Section 61 and basically includes all income from any source, unless specifically excluded by the tax law. This would include (among other things):   * Wages and other forms of compensation * Interest (excluding tax-exempt interest, e.g., interest from municipal bonds) * Dividends * Alimony (but not child support) * Business income (or losses) * Capital gains (or losses) – subject to limitations * The taxable amount of distributions from IRAs, pensions, and annuities * Rental income (or losses) * Farm income (or loss) * Taxable amount of Social Security benefits   Thus, Gross Income is the **broadest measure of income.** |

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| **Adjusted Gross Income (AGI)**  ***Adjusted Gross Income (AGI)***, as its name suggests, is an individual’s income after certain adjustments are made to gross income. Key adjustments for our purposes are deductions for contributing to an IRA and various self-employment deductions. We will learn more about AGI later. |

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| **Taxable Income**  ***Taxable income*** is equal to AGI minus **standard or itemized deductions,** and **minus** **personal and dependency exemptions.**  Every taxpayer is granted a standard tax deduction (think of it as an estimate of deductions that could be claimed by most people if they bothered to itemize), but some filers can increase total deductions by itemizing (listing) specific deductions to which they are entitled.  Taxpayers are entitled to some minimum level of income for their own care that is exempt from taxation. Furthermore, the amount exempt from taxation should be greater for taxpayers who also have dependents to support. Thus, an exemption amount is deducted from income for most taxpayers (phased out for high income taxpayers) and the taxpayer’s dependents. |

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| **Tentative Tax**  ***The Tentative Tax*** is determined by multiplying a person’s individual **tax rate** (tax rates will be covered in greater detail later in this lesson) by their taxable income. Rates may vary based on types of income. Possible adjustments are then made to determine whether the ***Alternative Minimum Tax (AMT)*** should be applied.  The ***Alternative Minimum Tax*** is a separate income tax system that operates parallel to the regular income tax. Its purpose is to prevent the wealthy from paying little or no income taxes. By targeting areas of tax preference in the regular income tax calculation, it helps assure that each taxpayer pays some minimal level of income tax. |

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| **Equals Income Tax Liability**  The ***tax liability*** is equal to a person’s tentative tax minus any **tax credits**. Note, however, that other taxes may also be due, such as self-employment tax or household employment taxes (see lines 58 to 62).  ***“Tax credits”*** are dollar-for-dollar reductions in the taxpayer’s tax liability. Some of these credits provide tax breaks for low-income taxpayers, while others are available to taxpayers at all income levels. There are two types of tax credits, refundable and non-refundable, which will be discussed in more detail later in this lesson. |

Now that you have become familiar with the basic tax formula, let’s look at Form 1040 itself. This copy has been marked to show you where each element of the basic tax formula is represented. Take a couple of minutes to read through each section. **Scroll through the document to view each section.**

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## Tax Terminology

In preparation for a closer examination of each section of Form 1040, it is important that you become familiar with some key terms that will be used throughout this course.  **Click on each term to learn more.**

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| **Exclusions** |
| ***Exclusions*** are items specifically excluded from gross income. They have specified IRC sections, which generally range from Code Section 101-139. A few examples of exclusions would include the receipt of child support, inheritances, and welfare benefits. |
| **Deductions** |
| There are two types of ***deductions***, which are mutually exclusive. Basically, there are deductions “for AGI” and “from AGI.”  **Deductions “for AGI”**   * Deductions “for AGI” are deductions on the front page of Form 1040 that are specifically allowed by law for deriving Adjusted Gross Income. * The final number on the front page of Form 1040 will be the taxpayer’s Adjusted Gross Income. * Since AGI is the last line on the front of the tax return and all adjustments “for AGI” occur above that line, such adjustments are commonly referred to as “above-the-line” adjustments.   **Deductions “from AGI”**   * Deductions “from AGI” are expenses of a personal nature, specifically allowable as a deduction on the back page of Form 1040 (utilizing Schedule A, if itemizing deductions) after AGI has been computed. * All deductions on the back page of Form 1040 (utilizing Schedule A, if itemizing deductions) are deductions “from AGI.” * Since all deductions “from AGI” are on the back of the return, following the AGI line, they are frequently referred to as “below-the-line” adjustments. |

## Tax Credit versus Tax Deduction

Additionally, you need to be able to distinguish between tax credits and tax deductions. Remembering the basic tax formula, recognize that ***tax credits*** are subtracted after calculating the tentative tax, which means they are subtracted after the individual’s tax rate has been applied. Keeping this in mind, you should recognize that tax credits are dollar-for-dollar reductions in the individual’s total tax liability.

On the other hand, ***tax deductions*** are applied before arriving at the individual’s taxable income. This means they are applied before applying the individual’s tax rate. Therefore, tax deductions are not dollar-for-dollar reductions in an individual’s tax liability. So, tax credits are **NOT** equivalent to tax deductions.

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| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income**  Less the greater of:  a) Standard ***deduction*** or  b) Total itemized ***deductions***  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less ***tax credits***  Plus other taxes  **Equals Income Tax Liability** |

**Calculating Deductible Equivalents of Tax Credits**

Calculating the deductible equivalent of a tax credit is a simple, but important calculation. Use the following formula:

**Tax Credit ÷ Marginal Tax Rate = Deduction Equivalent**

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| **Examples**  1. For an individual in the 33% tax bracket, what size deduction would be the equivalent of a $100 tax credit?  $100/.33 = **$303.03**  A tax deduction of $303.03 would give an individual in the 33% tax bracket the same tax savings as a $100 tax credit.  2. If a client in the 28% tax bracket were given the option of taking a $100 tax credit or a $300 tax deduction, which would you suggest?  $100/.28 = **$357.14**  In this case, the client should take the tax credit because it results in a deduction equivalent that is greater than the $300 deduction. | |

## Sources of Income

Having covered some key terms, let’s now turn our attention to the first section of the basic tax formula: ***gross income***. While there are many sources of income, the following are the primary income sources that are important to know for completing a tax return. **Click each term to learn more.**

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| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income**  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

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| **Earned Income** |
| Earned income is that which a person receives in return for his or her labor, either through self-employment or through being an employee. |
| **Unearned Income** |
| Unearned income is that which is received from sources other than a person’s labor, such as dividend payments on a stock, interest payments on a bond, capital gains, or payments received as a result of copyright, patents, or trademarks. Special rules may apply to unearned income, such as lower rates for qualified dividends and long-term capital gains, as discussed on the following pages. |
| **Alimony** |
| Alimony is also a source of income. If you look at Form 1040, Line 11, you will see that there is a specific line for alimony to be included as taxable income. |

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| DocumentationIcon_32px | **Click the icon to learn more about gross income inclusion.** |

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| How do we know when to include something in gross income?  Basically, if the person is a ***calendar year taxpayer***, the tax year ends on December 31. Generally, anything that happens during the 12 months from January 1 to December 31 is included in gross income.  However, a ***fiscal year taxpayer*** can have a twelve-month tax year that ends with any month. For the most part, fiscal tax years are confined to businesses and estates. |

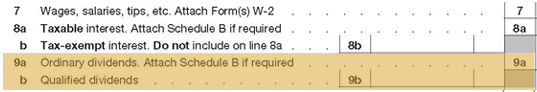
## Special Rules Regarding Unearned Income

While it is beyond the scope of this course to examine every possible source of gross income, the next few pages will explore some of the special rules regarding unearned income. We will focus primarily upon rules you are likely to encounter on a routine basis when working with affluent clients. In particular, we shall examine the tax rules associated with:

* Dividends
* Capital Gains and Losses
* The Wash Sale Rule
* Worthless Securities
* Taxation of Options
* Annuities

## Ordinary and Qualified Dividends

Ordinary dividends are entered on line 9a of Form 1040.



The distinction between ordinary dividends (taxed at ordinary income tax rates of up to 39.6%) and qualified dividends (taxed at a maximum of 20%) is of vital importance for any client receiving significant dividend income. Qualified dividend rates in 2016 follow:

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| * 20% - if the taxpayer is in the top ordinary income tax bracket of 39.6% * 15% - if the taxpayer’s ordinary income tax bracket is lower than 39.6% and higher than 15% * 0% - if the taxpayer’s ordinary income tax bracket is 15% or less |

While qualified dividends are included in line 9(a), note that they are segregated out on line 9(b) to facilitate identifying them and applying the lower rate when it comes time to compute the tax.

To qualify for this special tax rate as a qualified dividend, the following conditions must be met:

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| 1. The dividends must have been paid by a U.S. corporation or a qualified foreign corporation. 2. The dividends are not of type listed by the IRS as “dividends that are not qualified dividends.” This includes dividends that are:  * Capital gain distributions * Dividends paid on deposits paid by banks and savings and loans (these amounts are reported as interest) * Dividends from tax-exempt organizations or a farmer’s cooperative. * Dividends paid by a corporation on employer securities that are held through an employee stock ownership plan (ESOP) maintained by that organization  1. The taxpayer must meet the holding period described below. |

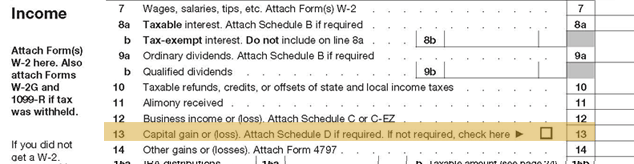
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| DocumentationIcon_32px | **Click the icon to learn more about the holding period.** |

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| **Holding Period**  As the preceding conditions show, most domestic stock dividends are potentially qualified. But before they can be designated as such, the taxpayer must meet the holding period requirement. To determine if a taxpayer meets the holding period requirement, look within the window of time 60 days before and 60 days after the ex-dividend date. If the stock was held for more than 60 days within that 121-day window, then it meets the holding period to qualify for the lower taxation.\*  timewindow  \* Note, however, that when dealing with dividends on preferred stock, you must have held the stock for more than 90 days during the 181-day period that begins 90 days before the ex-dividend date ***if*** the dividends are attributable to periods totaling more than 366 days. |

## Capital Gains Income

Capital gains on assets are generally reported on line 13 of Form 1040. Generally speaking, ***capital gains and losses will be*** ***netted against each*** ***other*** on the front page of Schedule D a copy of which can be downloaded and printed by clicking here.

Any net gains from Schedule D will be recorded on line 13 of Form 1040. Net losses will be reported on that line up to $3,000, with the balance carried forward to the next year. If the gain or loss was associated with assets used in a trade or business, then they will be reported on line 14.



The key principle behind capital gains taxation is the ***recovery of capital doctrine.*** This doctrine states that when a taxable sale or exchange occurs, the seller may be permitted to recover his or her investment in the property before recognizing a gain or loss. In other words, the IRS is not going to tax an individual on the entire amount of the sale of property. In general, only the gains are taxed.

To understand how this doctrine is applied in the recognition of capital gains and losses, there are some key concepts that must first be understood:

* Adjusted Basis
* Realized Gains and Losses
* Recognized Gains and Losses
* Long-term and Short-term Holding Periods

We will discuss these concepts on the next three pages, followed by a discussion of other considerations associated with wash sales and worthless securities.

Schedule D

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## Adjusted Basis

The *adjusted basis* essentially measures the amount of a taxpayer’s net investment in an asset. At any point in time, if the taxpayer sells the asset, the taxpayer’s value in the asset is the adjusted basis. It is generally calculated using the formula on the right. Upon sale of the asset, any proceeds up to the adjusted basis will be treated as a recovery of capital and excluded from taxation.

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| **Adjusted Basis**  **Cost basis of the asset**  + **Sales commissions**  + **Capital additions**  - **Capital returns**  = Adjusted basis |

**Click on each of the highlighted terms to learn more.**

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| **Cost Basis of the Asset** |
| The ***cost basis*** is the taxpayer’s original basis in the property. In most cases, this means the cost of the asset when purchased. For example, if Michael purchases 1,000 shares of stock for $60,000, his cost basis is $60,000. |
| **Sales Commissions** |
| If ***sales commissions*** are associated with the purchase of the asset, then these are treated as part of the investment and added to the cost basis. For example, if Michael paid a brokerage commission of $50 on his purchase of 1,000 shares for $60,000, then the $50 broker’s commission is added to the basis of the stock. |
| **Capital Additions** |
| ***Capital additions*** increase the value of the asset and are commonly associated with real property. In general, capital additions must increase the usefulness of the asset by more than one year in order to be added to the basis in the property. Examples of capital additions include replacing the plumbing, building additions, updating electrical systems, or replacing the roof. For example, if a house is purchased for $400,000 and another $70,000 is spent upgrading the plumbing and electrical wiring, the adjusted basis would become $470,000. |
| **Capital Returns** |
| ***Capital returns*** include depreciation, depletion, and amortization, which are often associated with business ownership. It also includes investments in securities where a portion of the income payment is a return of principal. For example, when investing in a GNMA bond, a portion of the income payments is a return of capital, requiring an adjustment in the cost basis.   |  |  | | --- | --- | | |  | | --- | | **GNMA (Ginnie Mae)**  ***GNMA***, also called “***Ginnie Mae***,” is the Government National Mortgage Association. It is a government agency to help finance government-assisted housing programs, and its mortgage pools consist of VA and FHA-insured mortgages. | | |

## When to Recognize Gains and Losses

A ***realized gain or loss*** is the actual gain or loss realized on the sale of an asset. Until a sale occurs, there are only adjustments to basis. For example, assume Terri buys an acre of land for $10,000. Three years later, it is worth $12,000. If Terri keeps the land, she simply has a basis of $10,000. However, if she decides to sell it, she would use her basis to calculate a realized gain of $2,000. If she sold it through a realtor, who charged a $750 commission, this would reduce Terry’s gain, resulting in a realized gain of $1,250.

Part, all, or none of the realized gain or loss upon the sale of an asset will be recognized. The ***recognized gain or loss*** is the portion of the realized gain or loss that is considered in the computation of tax liability. Therefore, “recognition” generally means that the result of a transaction is considered to be taxable.

Generally speaking, unless investment assets are held in a tax-deferred retirement plan, all of the realized gain and loss in investment accounts will be recognized, although some of the net losses may be carried forward to future years (as will be discussed further). But be careful, because this does not apply for all assets. For example, provided certain ***conditions*** are met, taxpayers can currently exclude from taxation $250,000 ($500,000 if married filing jointly) of capital gain on the sale of their principal residence. This special exclusion rule may only be used to exclude the gain from a sale of a principal residence once every two years.

**Click on each condition to learn more.**

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| **Overview** | To qualify for this special tax treatment, the residence must be the ***principal residence***, defined by the conditions listed here |
| **Taxpayer’s Facts and Circumstances** | The principal residence is determined by the ***facts and circumstances of taxpayers***. This would include where they are registered to vote, spend a majority of their time, have their automobile registered, and where their doctor and other professionals are located. |
| **2 Out of 5 Years** | The taxpayer must reside at the principal residence for at least ***2 out of 5 years*** preceding the sale of the home. This exclusion can be used more than once if this qualification can be met again. |
| **Two Properties** | If a taxpayer alternates between ***two properties***, the property used most often will ordinarily be considered the principal residence. |
| **Not Restricted to an Actual House** | The principal residence is not restricted to an actual house. Houseboats, trailers, or stocks held by a tenant stockholder in a cooperative housing development could qualify.  **Example**  **Question**: Dale bought a home in three years ago for $230,000. Dale lived in the home for three years, selling it in the current year for $320,000. Would Dale include the gain as taxable income?  **Answer**: *Dale would NOT include the gain of $90,000 as taxable income when he sells the home.*  **Question**: What if Dale sells the home for $190,000? Would he be able to deduct the loss?  **Answer**: *The answer is no. This is a personal loss, for which there is no deduction.* |

## Holding Period

Upon recognition of a capital gain or loss, its taxation will be determined on the basis of its ***holding period***. The holding period refers to the amount of time a taxpayer holds an asset. Upon sale of the asset, the holding period determines whether the gain or loss is long-term or short-term.

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| Long-Term  **Long-term** is generally defined as one year and one day. |

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| Short-Term  **Short-term** is generally one year or less. |

For most transactions, it is fairly easy to determine the holding period by comparing the purchase and sales dates. But some assets may present problems in determining the exact date of acquisition or sale. For example, with stocks and bonds that are traded on an exchange or over-the-counter market, do you use the trade dates or settlement dates? The answer is that the holding period begins on the day following the day of purchase (i.e., the trade date), and ends on, and includes, the date of sale (the trade date).

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| **Example**  **Select the correct answer.**  An individual purchased 100 shares of Amazon on January 14, Year 1 (trade date), and sold them on January 14, Year 2 (trade date), for a $600 gain. Is the $600 gain short-term or long-term?   * **Short-term**   **Correct.** The trade dates were exactly one year apart; therefore it is a short-term gain. Had the shares been held for one more day, the gain would have been taxed as a long-term gain.   * Long-term   **Incorrect.** The trade dates were exactly one year apart; therefore it is a short-term gain. Had the shares been held for one more day, the gain would have been taxed as a long-term gain. |

## Wash Sale Rule

Being familiar with the process of netting capital gains and losses is a fairly important concept. This is especially true in the investment world, where the netting of capital gains and losses is often taken into consideration when making decisions to sell securities. This is particularly true as investors approach year-end:

* When an individual investor approaches year-end with realized net gains, this may present an opportunity to go ahead and sell some investments that have depreciated in value, thereby utilizing the unrealized losses to offset the realized gains.

However, there are some restrictions on strategies that can be utilized. In particular, you should be familiar with the ***wash sale rule***. A wash sale occurs when an investor sells or trades a security at a loss and, within 30 days before or after the sale, the investor:

* Acquires (by purchase or taxable exchange) substantially identical stock or securities, or
* Acquires a contract or option to buy substantially identical stock or securities.

When this occurs, part or all of the loss on the sale is disallowed and must be added to the cost of the new stock or securities. In this manner, the loss deduction is postponed until disposition of the new stock or securities. Furthermore, the holding period for the new purchase will include the holding period of the stock or securities sold.

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| **Example**  An investor purchases 100 shares of XYZ stock for $1,000. At a later date, the investor sells the shares for $700 and within 30 days repurchases 100 shares of XYZ stock for $800. Since this is a wash sale, the investor cannot deduct the $300 loss on the sale. The investor must add the $300 to the basis of his new purchase, bringing it to $1,100. As you can see, if he were to immediately sell his new purchase for $800, he would recognize the same $300 loss. Thus, this process effectively “washes” the first sale and defers to loss deduction into the future. |

## Worthless Securities

Special rules are associated with the recognition of losses on worthless securities. ***Worthless securities*** are stocks, stock rights, and bonds in a company that has gone completely out of business, which means the shares are no longer trading and generally, no assets are available to pay the company's debts. Worthless securities are generally treated as a capital loss, but the date of worthlessness often places them in the category of a long-term capital loss, even if the investor held the security for less than a year before the company went out of business. This happens because **the capital loss on a worthless security is not recognized until the last day of the calendar year in which it became worthless.**

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| No Longer Trading  If XYZ Corp is trading on the New York Stock Exchange, but after filing for bankruptcy begins trading on the bulletin board for pennies per share, it is not a worthless stock. The stock must actually be worthless – not redeemable for any amount of money |

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| Example  Dave purchases 100 shares of Widgets, Inc. at $25/share in October of the previous year Widgets, Inc. goes out of business on February 1 of the current year. How will Dave report his loss in the following circumstances?   1. **Dave sold the stock on January 31 of the previous year.**   If Dave sold the stock on January 31, he would have held the stock for less than a year and would report a short-term capital loss in the previous year   1. **Dave was still holding the stock when the company went out of business.**   If Dave were still holding the stock in February, he would have a worthless stock, for which the worthlessness would have been deemed to occur on December 31 of the current year. Dave would report a long-term capital loss in the current year.  **NOTE:** Direct clients to contact a tax professional to discuss and understand the tax consequences of writing off a “worthless security.” |

## Option Transactions

With most securities, it is easy to identify when capital gains occur. When a stock or bond is sold, a gain or loss occurs. But options can be a bit trickier because there are several different scenarios whereby capital gains and losses may occur. Therefore, it is worth taking a closer look at how option transactions are reported.

**What is an option?**

In its simplest form, an option is the right to buy or sell property at an agreed price. One party writes (creates) the option; the other party purchases the option. An expiration date is specified in the option agreement, after which all rights to buy or sell the underlying property is forfeited.

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| Property  **Property** would include stock, commodities, currency, index, or debt. |

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| Example  **Question**: Ryan purchases an option to buy 1,000 shares of ABC Corporation stock on June 10 at an exercise price of $25. On June 10, ABC Corporation stock is trading at $30. Should Ryan exercise the option?  **Answer:** *Yes. Ryan would exercise the option because he is purchasing shares for $25.00/share that are worth $30.00/share.*  **Question:** What if the shares were trading at $20 on June 10?  **Answer:** *In that case, Ryan would not exercise the option and would lose the fee he paid for the option.* |

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| Exercise Price  The ***exercise price*** (also called ***strike price***) is the price at which an options contract may be exercised. In this example, Ryan has the option of purchasing shares for $25 each, no matter what price they are trading at on June 10. |

**How are options taxed?**

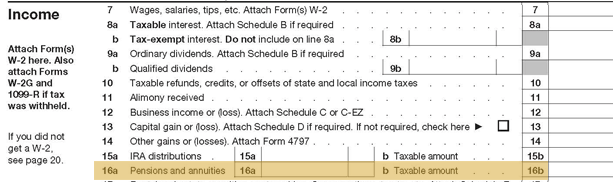
The writing or purchase of an option is not a taxable event. How the option will be ultimately handled for tax purposes will depend upon whether the option is resold prior to expiration, expires unexercised, or is exercised. Let’s examine each situation. **Click on each scenario to learn more.**

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| **Resale of an option** |
| In many cases, an option is sold from one buyer to another buyer before its expiration date. The gain or loss from the sale or exchange of an option is of the same character as the property to which the option relates. Therefore, if the option were on a capital asset, the gain or loss would be treated as a capital gain or loss. Whether it is short-term or long-term would depend upon the period for which the option was held.  **Example**  Dave purchased an option on 100 shares of XYZ Corp for a premium of $500. The option has an expiration date of May 10th. Prior to May 10th, Dave sells the option for $600. In that case, Dave would report a capital gain of $100. |
| **Option expires unexercised** |
| When an option expires unexercised, it is treated just as a resale of the option. Upon expiration, the holder of the option would have a capital loss in the amount of the premium that was paid for the option, which is long-term or short-term depending on the holding period of the option, and the writer of the option would have a short-term capital gain in the amount of the premium received.  **Example**  On May 10th, Dave allowed the option to expire unexercised. Dave would report a capital loss of $500 and the writer of the option would report a capital gain of $500. |
| **Exercise of an option** |
| A ***call option*** gives the holder of the option the right to buy the underlying security at the exercise price; the writer of the call is obligated to deliver the security. The basis of the acquired asset will be the exercise price plus the premium paid (plus any commissions). The writer of the call, in determining gain or loss on sale of the asset, will add the amount of the premium received for the option to the price paid for the security (but may deduct any commission expense). The gain or loss will be short-term or long-term depending upon how long the security was held.  **Example**  Let’s assume Dave’s option on XYZ stock was a call option to buy 100 shares with an exercise price of $50 per share. If Dave exercises the option, he will pay $5,000 for the 100 shares. Ignoring any commissions, Dave’s basis in the newly acquired shares will be the $5,000 he paid for the shares plus the $500 he paid for the option to purchase them, or $5,500.  The writer of the option received a premium of $500 on the option and received $5,000 upon selling the shares. Thus, the writer had a total receipt of $5,500. If the writer’s basis in the shares had been $2,000, then the writer would have a $3,500 capital gain upon the sale of the shares (ignoring any possible commissions involved). |
| **Put Option** |
| A ***put option*** gives the holder of the option the right to sell the underlying security to the writer of the option at the exercise price; the writer is obligated to buy the security. When a put option is exercised, the holder of the option will determine gain or loss by deducting from the exercise price the amount of the premium paid. The basis of the security acquired by the writer of the put will be the exercise price minus the premium received for writing the option (plus any commissions paid.)  **Example**  Let’s assume Dave’s option on XYZ stock was a put option to sell 100 shares with an exercise price of $50 per share. If Dave exercises the option, he will sell his shares to the option writer for $5,000. But Dave had to pay $500 for the put option, which allowed him to sell them at the exercise price, so he gets to reduce the proceeds by that amount. Ignoring commissions and assuming his basis in the shares was $2,000, Dave would then have a capital gain of $2,500 ($4,500 - $2,000).  The writer of the put option has to pay $5,000 for the 100 shares of XYZ stock. But since the writer also received a premium of $500 when writing the option, the writer must reduce his basis by the $500 premium. Thus, the writer’s basis in the shares is $4,500.  **NOTE:** Direct clients to consult with a tax attorney to understand how their transactions should be reported rather than appearing to give tax advice. |

## Annuities

The final issue we will explore regarding the recognition of unearned income is the taxation of annuities. Income from annuities is reported on line 16a of Form 1040.

|  |
| --- |
| Annuities  Annuities are contracts (typically insurance contracts) that may provide income as a series of regular payments for a specific period of time or for life. A portion of each annuity payment is considered a return of capital. |



When an individual receives annuity payments, part of the annuity income payments will be included or excluded from taxable income. The portion of income payments that is excluded from taxation is determined by calculating the ***exclusion ratio***.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| |  |  |  | | --- | --- | --- | | **Exclusion Ratio** | **=** | **Investment in Contract** | | **Expected Return** | |

If the number of payments is known, then the expected return in the equation is simply the total of all the income payments. If it is a life annuity, then you total all the income payments within the annuitant’s life expectancy.

Once the exclusion ratio is determined, you simply multiply an income payment by the exclusion ratio to derive the amount of the income payment that is excluded from taxable income. This portion is simply a return of the investment in the annuity.

|  |
| --- |
| **Excluded Amount = Exclusion Ratio x Income Payment** |

Once the excluded amount is determined, then the taxable amount is simply the balance. Generally, payments received after the investment in the contract is recovered are fully included in income. This is best illustrated by the example below.

|  |
| --- |
| **Example**  **Select the correct answer.**  Susan pays $100,000 for a 10-year annuity that will pay her $1,500 per month Susan pays $100,000 for a 10-year annuity that will pay her $1,500 per month over the next 10 years. What is the taxable amount of her first income payment?   * $555.56   **Incorrect.** The exclusion ratio is $100,000/180,000 = .5556  Thus, 55.56% of $1,500, which is $833.40, would be excluded from taxation. The balance, which is $666.60, would be included in taxable income.   * $666.60   **Correct**! The exclusion ratio is $100,000/180,000 = .5556  Thus, 55.56% of $1,500, which is $833.40, would be excluded from taxation. The balance, which is $666.60, would be included in taxable income.   * $833.40   **Incorrect.** The exclusion ratio is $100,000/180,000 = .5556  Thus, 55.56% of $1,500, which is $833.40, would be excluded from taxation. The balance, which is $666.60, would be included in taxable income. |

## Review Exercise

1. **The final calculation in the basic tax formula is deducting any tax credits from an individual’s adjusted gross income.**

* True

**Incorrect.** The final calculation for figuring an individual’s tax liability is deducting any tax credits from the individual’s tentative tax and adding certain other taxes.

* **False**

**Correct!**

1. **All deductions listed on the back of Form 1040 are deductions that are taken out before a taxpayer’s AGI is figured.**

* True

**Incorrect.** Adjusted Gross Income is the final number on the front page of the 1040.

* **False**

**Correct!**

1. **Adjustments made on the first page of Form 1040 are referred to as being:**

* **Above-the-line**

**Correct!**

* Below-the-line

**Incorrect.**

1. **Which results in more savings in tax: a tax credit of $100 or a tax deduction of $100?**

* **A tax credit of $100**

**Correct!** A tax credit results in a dollar-for-dollar reduction in tax liability.

* A tax deduction of $100

**Incorrect.** A tax credit results in a dollar-for-dollar reduction in tax liability.

* Neither. They both result in the same tax saving

**Incorrect.** A tax credit results in a dollar-for-dollar reduction in tax liability.

1. **If you were in the 33% income tax bracket, which would be more beneficial: a $300 tax credit or a $1,000 tax deduction?**

* A $300 tax credit

**Incorrect.** The deduction equivalent of a $300 tax credit is $909.09 ($300 .33). Therefore, you would be better off taking the $1,000 deduction.

* **A $1,000 tax deduction**

**Correct!** The deduction equivalent of a $300 tax credit is $909.09 ($300 .33). Therefore, you would be better off taking the $1,000 deduction.

1. **Nick bought 10 shares of stock in XYZ Inc. 5 years ago at $25 per share. The stock is now worth $35 per share. If Nick sells his shares, which of the following statements would be correct?**

* Nick would have $100 of earned income, but would not pay taxes on it because of the recovery of capital doctrine.

**Incorrect.** Nick performed no labor for the $100. Try again.

* **Nick would receive $350 for the sale of the stock, of which he would not pay taxes on $250.**

**Correct!** Nick’s basis was $250, on which he would not pay taxes. However he would pay taxes on the $100 of unearned income.

* Nick would receive $350 of unearned income, of which he would not pay taxes on $250.

**Incorrect.** While it is true that Nick would not pay taxes on $250, all $350 would not be considered unearned income. Try again.

* Nick would receive $100 of unearned income, for which he would not pay taxes because of the recovery of capital doctrine.

**Incorrect.** Unearned income is subject to taxation. Try again.

* Nick would receive $100 of earned income and would not pay taxes on his original $250 because of the recovery of capital doctrine.

**Incorrect.** The $100 is not earned income. Try again.

1. **Barry purchases a $15 option to purchase stock, but sells it prior to the exercise date for $25. What would Barry report for this transaction?**

* **$10 capital gain**

**Correct!**

* $10 ordinary income

**Incorrect.** The option is for a capital asset; therefore, Barry would report a capital gain. Try again.

* $25 capital gain

**Incorrect.** Try again.

* $25 ordinary income

**Incorrect.** The option is for a capital asset; therefore, Barry would report a capital gain. Try again.

1. **Sharon purchased shares of stock on September 1 and sold them on September 1 of the next year. What type of gain or loss did she realize?**

* **Short-term gain or loss**

**Correct!** She had to wait one more day for it to be a long-term gain or loss.

* Long-term gain or loss

**Incorrect.** She had to wait one more day for it to be a long-term gain or loss.

1. **On September 1, a client sold 100 shares of XYZ stock that he had held for 2 years. He originally purchased the shares at $50 per share, but sold them at $30 per share. Two weeks after the sale, he purchased the shares back at $15 per share. What is his tax basis in this purchase?**

* $15 per share

**Incorrect.** Since this is a wash sale, the client must adjust the basis on the repurchase by adding back the loss he realized on the prior sale.

* **$35 per share**

**Correct!** Since this is a wash sale, the client must adjust the basis on the repurchase by adding back the loss he realized on the prior sale.

* $45 per share

**Incorrect.** Since this is a wash sale, the client must adjust the basis on the repurchase by adding back the loss he realized on the prior sale.

## Adjusted Gross Income

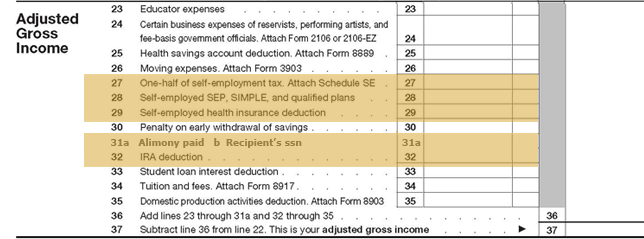
Once gross income is identified, the next step is to derive adjusted gross income (AGI) through a series of deductions. This is done in the bottom section of the front page of Form 1040, which can be viewed on this page. These adjustments are often referred to as “***adjustments FOR AGI***” as they are adjustments that are made to derive AGI. Adjustments that will be made on the back of Form 1040, after AGI has been derived, are frequently referred to as “***adjustments FROM AGI***.”

|  |
| --- |
| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income**  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

Take a few moments to look over the list of deductions available. The titles are fairly descriptive of the nature of the deductions. Three areas you are likely to encounter are:

* Line 27,28, and 29 – Self-Employed Deductions
* Line 31a – Alimony paid (not child support)
* Line 32 – IRA Deduction

We will take a closer look at the first two of these on the next two pages.



## Lines 27, 28, and 29 - Self-Employed Deductions

Lines 27, 28, and 29 provide potential deductions for those who are self-employed. Since many affluent clients will be self-employed, these deductions are likely to be appropriate for many of your clients and you should have a basic familiarity with them. **Click each deduction to learn more.**

|  |
| --- |
| **Line 27 – Self-Employment Tax** |
| On line 27 of Form 1040, an individual is allowed to deduct ***one-half*** ***of the net self-employment income tax***. The self-employment income tax is comprised of a Social Security (OASDI) tax and Medicare tax. The Social Security tax is 12.4%, and Medicare 2.9%. Therefore, the total tax is 15.3% of net earnings from self-employment. However, the maximum amount of income subject to the Social Security tax is $118,500 in tax year 2016. There is no maximum for the Medicare tax. |
| **Line 28 – Self-Employed SEP, SIMPLE, and Qualified Plans** |
| While the details of these programs are beyond the scope of this course, contributions made, within plan limits, by self-employed individuals to their SEP, SIMPLE, and qualified retirement plans are 100% deductible. |
| **Line 29 – Self-Employed Health Insurance Deduction** |
| Self-employed individuals are allowed a 100% deduction for health insurance premiums to the extent such amount is less than their net profit and any other earned income from their business. |

## Line 32 – IRA Deduction

Line 32 of Form 1040 is for deductible contributions to a Traditional Individual Retirement Arrangement (IRA). However, not all individuals are eligible for the deduction. **For those persons participating in an employer-sponsored plan** (qualified plan), deductible contributions to Traditional IRAs may be phased out based on their income.

|  |  |
| --- | --- |
| **Phase-Out of Deductibility to Traditional IRAs**  While it is always possible to make contributions of earned income to a Traditional IRA up to annual limits, the tax deductibility of those contributions is phased out if the individual meets two conditions:   |  | | --- | | Annual Limits  Contributions to a Traditional IRA are limited to the lesser of earned income or annual limits. |  1. The individual is an active participant in an employer-sponsored plan.   **AND**   1. The individual’s Adjusted Gross Income (AGI) exceeds specified limits. |

**Annual IRA Contribution Limits**

|  |  |
| --- | --- |
| **Year** | **Annual Limit** |
| **2016** | **$5,500\*** |
| **2015** | **$5,500\*** |
| *\*An additional “catch-up” contribution of $1,000 is allowed for individuals over age 50.* | |

The phase-out begins and ends with the following amounts of AGI, depending upon the filing status and whether or not both spouses actively participate in an employer-sponsored plan: **Click on the highlighted text to learn more.**

**Traditional IRA Phase-Out of Deductibility**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **All Parties in Employer - Sponsored Plan** | | | **Only One Spouse in Employer - Sponsored Plan** | | |
| **Year** | **Single Filer** | **Married: Filing Jointly** | **Married: Filing Separately** | **Participating Spouse Filing Jointly** | **Non-Participating Spouse Filing Jointly** | **Either Spouse Filing Separately** |
| 2016 | $61,000-$71,000 | $98,000-$118,000 | $0-$10,000 | $98,000-$118,000 | $184,000-$194,000 | $0-$10,000 |
| 2015 | $61,000-$71,000 | $98,000-$118,000 | $0-$10,000 | $98,000-$118,000 | $183,000-$193,000 | $0-$10,000 |

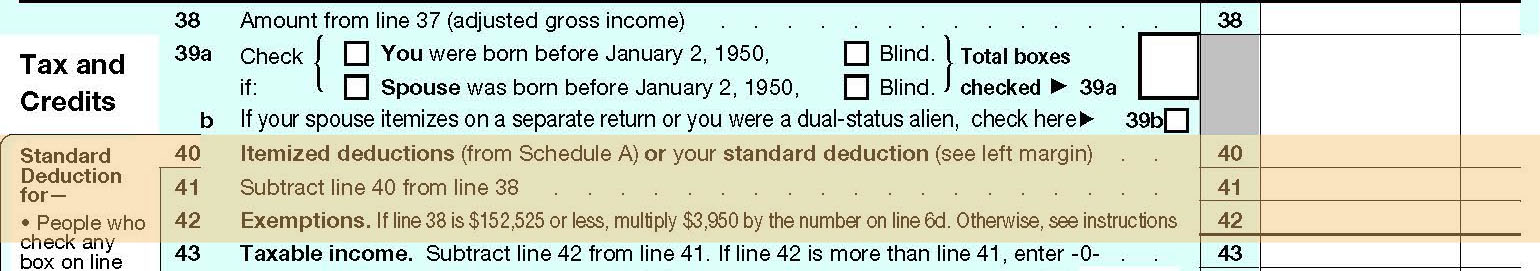
|  |
| --- |
| Single $61,000-$71,000  A single, 34-year-old individual is an active participant in an employer-sponsored plan. If this person makes a $2,000 contribution to an IRA in 2016, then:   * With AGI of $40,000, the $2,000 contribution would be fully deductible. * With AGI of $65,000, the $2,000 contribution would be partially deductible. * With AGI of $70,000, the contribution would not be deductible at all. |

## Deriving Taxable Income

Once adjusted gross income is determined, the next step is to subtract deductions and exemptions to derive taxable income. This is done on the back of Form 1040.

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| --- |
| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income**  Less the greater of:  ***a) Standard deduction or***  ***b) Total itemized deductions***  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

**Click here to see this section on the back of Form 1040.**



As part of calculating taxable income, each taxpayer generally has the option on line 40 of taking the standard deduction or itemizing deductions, using whichever one is greater. The size of the standard deduction will generally be determined by the taxpayer’s ***filing status***, but the amount is increased for those age 65 and over and for those who are blind. If the taxpayer chooses to itemize deductions, then the taxpayer will have to fill out and attach additional information.

|  |  |
| --- | --- |
| DocumentationIcon_32px | **Click the icon to learn more about filing status.** |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Filing Status  An individual’s filing status is determined on the last day of the tax year. The table below gives a brief description of each available filing status.   |  |  | | --- | --- | | **Filing Status** | | | Single | * Unmarried on the last day of the year * Does not qualify for head of household filing status * Legally separated under state law, under decree of divorce or separate maintenance * Widowed, but not qualifying widow(er) | | Married Filing Jointly (MFJ) | * Married couples may file a joint return. * Also file MFJ in the year a spouse dies | | Married Filing Separately (MFS) | * Married couples filing separate returns must identify themselves as such. | | Head of Household | * Unmarried on the last day of the tax year * Maintain a household for a dependent * Special rules apply to certain people who are married but live apart for the last 6 months of the year or are legally separated under state law. | | Surviving Spouse | * Also called qualifying widow(er) * Could file as Married Filing Jointly in the tax year the spouse died * Can file Surviving Spouse for 2 years after the death of a spouse, thereby using MFJ rates, if the surviving spouse maintains a household for a dependent child | |

On the following page, we will define the standard deduction, and then proceed to explore the itemized deductions.

## The Standard Deduction

The standard deduction is a fixed deduction allowed to taxpayers who do not itemize their deductions. The standard deduction is increased for individuals over the age of 65 and for blind persons. A person who is both blind and over the age of 65 may count the additional deduction twice. For example, a single filer for the 2016 tax year who is blind and over the age of 65 would be able to deduct $9,400 ($6,300 + $1,550 + $1,550).

|  |
| --- |
| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income**  Less the greater of:  ***a) Standard deduction or***  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

|  |  |
| --- | --- |
| DocumentationIcon_32px | **Click the icon to see a list of the standard deductions, which are based on filing status.** |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  | | --- | --- | --- | --- | | **Tax Year 2016 Standard Deductions** | | | | | **Filing Status** | **Standard Deduction** | **If Blind** | **If Over**  **Age 65** | | Single | $6,300 | + $1,550 | + $1,550 | | Head of Household | $9,300 | + $1,550 | + $1,550 | | Married Filing Jointly / Surviving Spouse | $12,600 | + $1,250 | + $1,250 | | Married Filing Separately | $6,300 | + $1,250 | + $1,250 | |
| |  |  |  |  | | --- | --- | --- | --- | | **Tax Year 2015 Standard Deductions** | | | | | **Filing Status** | **Standard**  **Deduction** | **If Blind** | **If Over**  **Age 65** | | Single | $6,300 | + $1,550 | + $1,550 | | Head of Household | $9,250 | + $1,550 | + $1,550 | | Married Filing Jointly / Surviving Spouse | $12,600 | + $1,250 | + $1,250 | | Married Filing Separately | $6,300 | + $1,250 | + $1,250 | |

**Standard Deduction for Dependents**

A dependent is basically a person who is financially supported by another person and who can be claimed as a dependent on the tax return of the person providing the support. When filling out the dependent's tax return, the 2016 standard deduction for dependents is generally limited to ***the greater of***:

* $1,050

**Or**

* The dependent’s earned income plus $350 not to exceed the regular standard deduction for non-dependents.

|  |
| --- |
| **Example**  **Question**: Jarrod is a junior in college who has earned income of $2,000 in 2016, plus interest income of $500. His parents can claim him as a dependent on their tax return. What is the standard deduction for Jarrod?  **Answer**: Jarrod’s standard deduction would be $2,350 ($2,000 + $350). |

Now you try one.

|  |
| --- |
| **Question**  **Select the correct answer.**  Emily is a freshman at the state university. In **2016**, she earns $8,000 working over the summer. If Emily is blind, and can be claimed as a dependent by her parents, what is her standard deduction on her **2016** tax return?   * $1,000   **Incorrect.** Emily’s earned income is greater than this amount. Try again.   * $6,200   **Incorrect.** You were correct to identify that Emily’s earned income exceeded the basic standard deduction, but forgot to include the fact that Emily is blind. Try again.   * **$7,850**   **Correct.** The standard deduction for Emily would be the full single standard deduction of $6,300 (2016), plus an additional $1,550 (2016) because she is blind. Remember that Emily, not her parents, receives the additional standard deduction.   * $8,000   **Incorrect.** The standard deduction for dependents cannot exceed the regular standard deduction. |

## Itemized Deductions

Itemized deductions are incurred expenses that are deducted from an individual’s adjusted gross income. A taxpayer’s itemized deductions may be limited by the itemized deduction phase-out rules.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Itemized deduction phase-out  There was no phase-out of itemized deductions in tax years 2009 through 2012. However, the American Taxpayer Relief Act of 2012 marked a return of itemized deduction phase-outs for taxpayers with adjusted gross income above certain limits.  A taxpayer’s itemized deductions are reduced when adjusted gross income in 2016 (as indexed) exceeds certain limits. A taxpayer must reduce his or her itemized deductions by 3% of the excess over the limits in the chart below. No more than 80% of a taxpayer’s itemized deductions may be lost under these rules.   |  |  | | --- | --- | | **Filing Status** | **2016 Adjusted Gross Income Phase-Out** | | Married Filing Jointly | $311,300 | | Head of Household | $285,350 | | Single | $259,400 | | Married Filing Separately | $155,650 |  |  | | --- | | Example 1  A single taxpayer has adjusted gross income of $459,400 in 2016. The taxpayer has $40,000 in itemized deductions before application of the phase-out rules. The excess adjusted gross income is $200,000 - calculated as $458,250 less $259,400. The taxpayer must reduce his or her itemized deductions by $6,000 - calculated as 3% of $200,000. The taxpayer may deduct only $34,000 as an itemized deduction.  Example 2  Assume the taxpayer in Example 1 has an adjusted gross income of $1,759,400. The excess adjusted gross income is $1,500,000 calculated as $1,759,400 less $259,400. Then, 3% of $1,500,000 is $45,000. In this case, the taxpayer would appear to lose all of his or her itemized deductions; however, the maximum reduction under these phase-out rules is 80% of the itemized deductions. Therefore, the taxpayer would deduct $8,000 as an itemized deduction. The $8,000 is calculated as follows: $40,000 times 80% maximum percent reduction equals $32,000 maximum dollar reduction. Hence, the deduction allowed is $8,000 calculated as $40,000 less $32,000. | |

Taxpayers who choose to file claiming itemized tax deductions must fill out Schedule A. **Click here to view and print a copy of Schedule A.**

Schedule A provides for the following deductions listed below.

|  |
| --- |
| **Medical and dental expenses** |
| Deductible unreimbursed medical expenses are subject to a floor of 10% of AGI (2016). This means that for a taxpayer with an AGI of $100,000, only medical expenses in excess of $10,000 (10% of AGI) would be deductible.  Deductible medical expenses include:   * Accident and Health Insurance Premiums  |  | | --- | | Accident and health insurance premiums are generally deductible only if these conditions are both met:   * The taxpayer paid the premiums with after-tax dollars (premiums paid from a Health Savings Account are not deductible) * The taxpayer paid the entire cost of the premium (if an employer paid for a portion of the premium then none of the employee’s premium payments are deductible by the employee |  * Prescriptions * Transportation and Lodging Essential to Medical Care * Capital Improvements that are Medically Required – **click here for an example**.  |  | | --- | | **Example**  For example, presume a doctor prescribed for a patient, after suffering a heart attack, to swim one mile every day. The patient, whose closest pool was 30 miles away, then constructed an indoor pool at a cost of $50,000, which increased the value of the home by $30,000. In this scenario, there are two questions to answer.  **1. Is the pool a deductible expense?**  *The answer would be yes. The pool is medically necessary and the closest one is 30 miles away.*  **2. How much could the patient deduct?**  *The patient would be able to deduct $20,000 (subject to the 10% floor). While the patient spent $50,000, the pool increased the value of the home by $30,000. Therefore, the patient is only out the additional $20,000.* |  * Qualified Long-Term Care (LTC) premiums are deductible up to limits based on age as published annually by the IRS (and subject to the 10% AGI limit) – **click here for details.**  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | **Example**   |  |  |  | | --- | --- | --- | | **Attained age before the close of the taxable year** | **2016 Maximum LTC Premium Deduction** | **2015 Maximum LTC Premium Deduction** | | 40 or less | $390 | $380 | | More than 40 but not more than 50 | $730 | $710 | | More than 50 but not more than 60 | $1,460 | $1,430 | | More than 60 but not more than 70 | $3,900 | $3,800 | | More than 70 | $4,870 | $4,750 | | |
| **Taxes you paid** |
| Taxpayers are given deductions for certain taxes that they have paid or will pay in the year for which they are filing their tax return. These taxes include:   * State and Local Income Taxes or general sales taxes\* * Real Estate Taxes * Personal Property Taxes   *\* This provision is available to all taxpayer,s but is especially attractive to residents of states with no state income tax.* |
| **Interest you paid** |
| The primary types of interest that are deductible are ***home mortgage interest*** and ***investment interest***.  The total value of the mortgage may limit the amount of interest that is deductible. For example, in the acquisition of a home, interest on the total mortgage amount up to **$1 million** is deductible. This dollar limit applies to the combined mortgages on both the primary and secondary home.  Interest on home equity debt is also deductible, subject to limitation. Home equity debt is a mortgage taken out after October 13, 1987, that:   * Does not qualify as home acquisition debt or as grandfathered debt, and * Is secured by your qualified home.   The deductible interest is limited to that generated by debt on the lesser of $100,000 or the total FMV of the home minus any home acquisition or grandfathered debt. For example, if the FMV of the home is $300,000 and the acquisition mortgage is $270,000, only interest on a home equity debt of $30,000 ($300,000 - $270,000) would be deductible.  ***Investment interest*** is any interest on debt incurred to purchase property held for investment purposes. Interest on debt incurred to purchase property held for taxable investment purposes is generally deductible. However, you cannot deduct interest expenses that were incurred to purchase or carry tax-exempt investments. For example, interest paid on debt used to purchase municipal bonds would generally be non-deductible because the municipal bond interest is generally excluded from income.  Furthermore, investment interest generally may only be deducted up to the extent of net investment income. **Click here for an example.**   |  | | --- | | **Example**  Bill takes out a loan to purchase property (his only investment). If he receives $500 in income from that property, he may not deduct any more than $500 in interest expenses in that year. However, Bill may deduct any additional interest the following year, provided his net investment income is at least as much as his investment interest. | |
| **Gifts to charity** |
| The IRS identifies gifts to certain types of charities as qualified to be deducted from AGI. If the gift is to a qualified charity, a deduction can be taken equal to the asset’s market value at the time of the gift (although the taxpayer may encounter limits on the amount that can be deducted, based upon the taxpayer’s AGI, the nature of the property given, and the type of charity involved).  Since the deduction is based on current market value at the time of the gift, it is preferable to gift long-term appreciated property. When gifting certain long-term appreciated property (such as stocks and bonds), no capital gain is realized upon the gift, yet a full deduction is made for its current market value, ***subject to a 30% of AGI limitation rule.*** Subsequently, the charity can sell the asset and pay no capital gain taxes due to its tax-exempt status. If the appreciated property has not been held long-term at the time of making the gift, there is still no recognition of gain when making the gift but the deduction will be limited to the basis in the asset. **Click here for an example.**   |  | | --- | | **Example**  Fred gave 100 shares of XYZ stock he held long-term to the American Red Cross. His basis in the shares was $1,200 and the current market value at the time of the gift was $2,000. Fred can claim a $2,000 deduction on his income tax return, subject to certain AGI limitations. If the stock had not been held long-term, Fred’s deduction would be limited to his $1,200 basis in the stock.  While the American Red Cross will assume Fred’s basis of $1,200, it can nonetheless sell the stocks for $2,000 and pay no taxes on the realized gain because of its tax-exempt status. | |
| **Casualty or theft loss** |
| For individuals who endure casualty or theft loss, tax deductions are available. ***Casualty loss*** is defined as a sudden, unusual, and unexpected loss. **Theft** is the act of taking something from someone unlawfully. There are several rules generally applied to deducting a loss from casualty or theft. |
| **Miscellaneous 2%** |
| There are certain deductions labeled as “miscellaneous” that may be claimed as itemized deductions. For the most common of these deductions, the taxpayer must reduce the total by 2% of their adjusted gross income. These include unreimbursed employee expenses, investment advisory and custodial fees and certain investment expenses, tax preparation fees, union dues, safe deposit fees, certain license and regulatory fees, and others.  Others are not subject to this reduction. These include gambling losses up to the amount of gambling winnings, amortizable premium on taxable bonds, loss from other activities from a K-1, repayments of more than $3,000 under a claim of right, federal estate tax on income in respect of a decedent, impairment-related work expenses of persons with disabilities, and certain casualty and theft losses from income-producing property. |

**Schedule A**

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## Personal and Dependency Exemptions

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| --- |
| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income (AGI)**  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  **Less Personal and Dependency Exemption(s)**  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

After calculating either standard or itemized deductions, the final step before arriving at Taxable Income is to deduct any personal and dependency exemptions. Taking the standard deduction versus itemizing deductions will have no bearing on these exemptions. Each exemption is $4,050 in 2016. Effective for 2013 and later tax years, the personal and dependency exemptions are subject to adjusted gross income exemption phase-outs.

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Personal and dependency exemptions  Do not confuse the deduction for personal and dependency exemptions with the standard or itemized deductions. Every taxpayer is entitled to the personal exemption, provided they do not exceed certain adjusted gross income exemption phase-outs.   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Adjusted gross income exemption phase outs (2016, as indexed)   |  |  |  | | --- | --- | --- | |  | **Adjusted Gross Income (AGI)** | | | **Filing Status** | **Full Exemption if AGI is below** | **No exemption if AGI is above** | | Married Filing Jointly | $311,300 | $433,800 | | Head of Household | $285,350 | $407,850 | | Single | $259,400 | $381,900 | | Married Filing Separately | $155,650 | $216,900 | |   ***Noteworthy - Unlike the phase-out of itemized deductions, 100% of the exemption amount may be lost by taxpayers exceeding these AGI thresholds.*** |

**For further clarification, click on each exemption listed below.**

|  |
| --- |
| **Personal exemption** |
| Taxpayers are generally allowed to take one personal exemption for themselves and, if married and filing jointly, one for their spouse. |
| **Dependency exemptions** |
| Taxpayers are allowed one exemption for each individual they may claim as a dependent. If an individual is entitled to claim an exemption for a dependent, that dependent cannot claim his or her own personal exemption on his or her own tax return. |

## Review Exercise

1. **Larry is 55 years of age and wishes to make a contribution to his Traditional Deductible IRA from his earned income. Assuming he is not a participant in an employer-sponsored retirement plan and he makes the maximum contribution possible for 2016, what is his adjustment for AGI?**

* $3,000

**Incorrect.** Try again.

* $3,500

**Incorrect.** Try again.

* $4,000

**Incorrect.** Try again.

* $5,500

**Incorrect.** The additional catch-up contribution is $1,000. Try again.

* **$6,500**

**Correct!** His contribution limit is $5,500 plus an additional $1,000 for being 50 or older, both of which are fully deductible as an adjustment for AGI.

1. **Your client, who files as a single taxpayer, earns $250,000 and participates in an employer-sponsored retirement plan. She wishes to make a contribution into a Traditional IRA. You would be correct in advising your client that:**

* She cannot make a contribution because she participates in an employer-sponsored plan.

**Incorrect.** Only the deductibility of her contribution is impacted by her earned income and participation in an employer-sponsored plan. Try again.

* She cannot make a contribution because she participates in an employer-sponsored plan and her earned income is too high.

**Incorrect.** Only the deductibility of her contribution is impacted by her earned income and participation in an employer-sponsored plan. Try again.

* She can make a contribution, but not for the maximum amount because of her level of earned income.

**Incorrect.** Only the deductibility of her contribution is impacted by her earned income and participation in an employer-sponsored plan. Try again.

* **She can make a contribution up to the annual limit, but it will not be deductible as an adjustment for AGI.**

**Correct!** Only the deductibility of her contribution is impacted by her earned income and participation in an employer-sponsored plan.

1. **For a self-employed person, which of the following are deductible for AGI?**

**A. 100% of contributions to a self-employed SEP, SIMPLE, or Qualified Plan**

**B. 100% of health insurance premiums**

**C. 100% of net self-employment income tax**

* A only

**Incorrect.** This is not the only correct choice. Try again.

* B only

**Incorrect.** This is not the only correct choice. Try again.

* C only

**Incorrect.** Only half of net self-employment income tax is deductible. Try again.

* **A and B**

Correct!

* A and C

**Incorrect.** Only half of net self-employment income tax is deductible. Try again.

1. **For 2016, which of the following statements regarding the self-employment tax is correct?**

* The total tax is 16.3%.

**Incorrect.** The self-employment tax is 15.3%.Try again.

* The maximum amount of income subject to the Medicare portion of the self-employment tax in 2016 is $118,500.

**Incorrect.** There is no maximum amount of income subject to the Medicare portion of the self-employment tax. However, $118,500 (2016) is the maximum amount of income subject to the Social Security tax. Try again.

* **The Social Security or OASDI tax is 12.4%.**

**Correct!** The Social Security or OASDI portion of the self-employment tax is 12.4% of income in 2016.

* The Medicare tax is 3.9%.

**Incorrect.** The Medicare tax is generally 2.9% for self-employed taxpayers earning less than $200,000 (filing as Single, other limits apply to other filing statuses). An additional “employee-only” Medicare tax of .9% applies to taxpayers earning more $200,000. Remember that the self-employed taxpayer pays both “employee” and “employer” portions of self-employment taxes. Try again.

* All of the above are correct.

**Incorrect.** Try again.

1. **For a client filing as “Single” with AGI of $125,000 in 2016 (including net investment income of $8,000) what are the total deductions from AGI that can be claimed from the following income and expenses**

**Gift to church = $20,000**

**Property taxes = $8,000**

**Car loan and credit card interest = $3,000**

**Margin account interest = $2,000**

**Medical expenses = $4,000**

* $37,000

**Incorrect.** Some expenses are not deductible. Try again

* $34,000

**Incorrect.** Indeed, the car loan and credit card interest are not deductible; but these are not the only expenses that are not deductible. Try again.

* **$30,000**

**Correct!** Everything except for the medical expenses (which do not exceed 10% of AGI) and the car loan and credit card interest is deductible. The client’s deduction is not reduced by the itemized deduction phase-out rules because adjusted gross income is less than the phase-out limits.

* $28,000

**Incorrect.** There is at least one other deductible expense available. Try again.

1. **The 2016 standard deduction for a person who can be claimed on another person's return as a dependent is limited to $1,050.**

* True

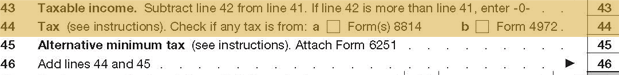
**Incorrect.** It is limited to the GREATER of $1,050 or the dependent’s earned income +$350 (not to exceed the regular standard deduction for non-dependents).

* **False**

**Correct.** It is limited to the GREATER of $1,050 or the dependent’s earned income +$350 (not to exceed the regular standard deduction for non-dependents).

## Calculating the Tentative Tax

After reducing AGI by the standard or itemized deductions, and by personal and dependent exemptions, the resulting Taxable Income (line 43) is used to calculate the taxpayer’s Tentative Tax, and the result is entered on line 44. **This portion of the tax return may be viewed by clicking** here.



|  |
| --- |
| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income (AGI)  **Adjusted Gross Income (AGI)**  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  **Taxable Income**  **Multiplied by personal tax rate**  **Adjusted for Alternative Minimum Tax (AMT)**  **Tentative Tax**  Less tax credits  Plus other taxes  **Equals Income Tax Liability** |

The marginal tax rate system is used to compute this tax. The first thing to understand about this system is that individuals will be placed in certain tax brackets (tax rates) based on their income and filing status. The 2016 federal brackets are as follows:

|  |
| --- |
| **2016 Marginal Income Tax Rates (Brackets)**   * 10% * 15% * 25% * 28% * 33% * 35% * 39.6% |

Depending upon filing status, these marginal rates are assigned to different incremental levels of Taxable Income. An individual’s total taxable income will NOT all be taxed at the highest bracket reached. Rather, only the amount of income that is within the range assigned to a marginal rate will be taxed at that particular rate.

|  |  |  |
| --- | --- | --- |
| |  |  | | --- | --- | | DocumentationIcon_32px | **Click the icon to view an example.** | |

|  |
| --- |
| **Example**  The following example should help clear up any confusion.  The 2016 Marginal Tax Rates for unmarried individuals (other than surviving spouses and heads of households) are listed below, along with the ranges to which they apply:  10% on amounts up to $9,275  15% on amounts over $9,275 and up to $37,650  25% on amounts over $37,650 and up to $91,150  28% on amounts over $91,150 and up to $190,150  33% on amounts over $190,150 and up to $413,350  35% on amounts over $413,350 and up to $415,050  39.6% on amounts over $415,050  Another way of looking at it is:  10% on the first $9,275  15% on the next $28,375 (This equals $37,650 - $9,275)  25% on the next $53,500 (This equals $91,150 - $37,650)  28% on the next $99,000 (This equals $190,150 - $91,150)  33% on the next $223,200 (This equals $413,350- $190,150)  35% on the next $1,700 (This equals $415,050 - $413,350)  39.6% on the balance  **Q: What would the tax be for an individual with $7,000 of taxable income?**  A: $7,000 x .10 = **$700**  **Q: What would the tax be for an individual with $12,000 of taxable income?**  A: The first $9,275 would be taxed at 10%, with the balance at 15%:  ($9,275 x .10) + ($2,725 x .15) = **$1,336.25**  **Q. What would the tax be for an individual with $50,000 of taxable income?**  A: The first three tax rates would be utilized:  ($9,275 x .10) + ($28,375 x .15) + ($12,550 x .25) = **$8,271.25** |

## Net Investment Income Tax (NIIT)

Effective for 2013 and later tax years, a 3.8% tax is assessed against investment income. The purpose of the NIIT is to provide additional funding to Medicare. This tax marks the first time in our nation’s history that investment income has been subject to Medicare taxes.

The NIIT is also referred to as the 3.8% Medicare Surtax or 3.8% Additional Medicare Tax. This tax is payable on the **lesser of** net investment income or modified adjusted gross income in excess of the following thresholds. Modified adjusted gross income will generally be equal to adjusted gross income as normally calculated for most taxpayers.

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| --- |
| Investment Income  Investment income for purposes of the NIIT is comprised of more than merely portfolio income and includes all of the following:   * Interest * Dividends * Capital gains * Rental and royalty income * Income from annuities purchased with the taxpayer’s after-tax dollars (referred to as nonqualified annuities) * Income from certain businesses (e.g., Limited Partnerships, Sub S Corporations, and Limited Liability Companies) in which the taxpayer is not actively involved in the business |

|  |  |  |
| --- | --- | --- |
| **Filing Status** | **2016 AGI Threshold** | **2015 AGI Threshold** |
| **Married Filing Jointly** | $250,000 | $250,000 |
| **Married Filing Separately** | $125,000 | $125,000 |
| **Single** | $200,000 | $200,000 |

Earned income and excluded income is not subject to the 3.8% Net Investment Income Tax.

|  |
| --- |
| Earned Income and Excluded Income  The following types of income are not subject to the NIIT:   * Wages * Unemployment compensation * Self-employment income * Operating income from a business in which the taxpayer is actively engaged in the business * Social Security benefits * Alimony * Distributions from Qualified Plans, IRAs, 403(b) Plans, and 457(b) Plans * Tax-exempt interest |

The calculation of this tax is best illustrated by example. Assume that your clients are married and file jointly. Their adjusted gross income is $400,000. They have investment income of $210,000 and investment expenses of $10,000. Their net investment income tax is $5,700 calculated as follows:

|  |  |
| --- | --- |
| **Example of NIIT Calculation** | |
| **Factor** | **Amount** |
| Adjusted Gross Income | $400,000 |
| Less threshold AGI, married filing jointly (from chart above) | $250,000 |
| Excess of AGI over threshold | $150,000 |
| Net Investment Income  ($210,000-$10,000) | $200,000 |
| Lesser of excess AGI or Net Investment Income | $150,000 |
| NIIT= 3.8% of $150,000 | $5,700 |

## Calculation of Capital Gains Taxes

Not all income is taxed at the marginal rates discussed previously. We have already pointed out that lower rates are applicable for qualified dividends. They are also available for long-term capital gains. We previously discussed the fact that capital gains and losses are netted for recognition on the front of Form 1040; we now address how taxes are assessed upon them. The tax on capital gains and losses is calculated at the following rates:

|  |
| --- |
| * Short-term capital gains are taxed at ordinary rates. * Long-term capital gain taxes are assessed at 20% (taxpayers in the highest tax bracket), 15% (taxpayers in the next four tax brackets), or 0% (taxpayers in the bottom two tax brackets). * An additional 3.8% Medicare tax may apply to capital gains of taxpayers with Modified Adjusted Gross Income above certain levels. * Excess capital losses are deductible against ordinary income up to $3,000 ($1,500 if married and filing separately); the balance is carried over until the next year. |

This is quite simple if you are dealing with only one type of gain or loss, or if you only have losses and no gains, or gains and no losses. This is illustrated in the chart below:

|  |  |
| --- | --- |
| **If you have:** | **How you are taxed in 2016:** |
| **Short-term gain only** | Taxed at ordinary income tax rates. An additional 3.8% NIIT may apply. |
| **Short-term loss only** | You can deduct up to $3,000 ($1,500 if married and filing separately) against other income and carry over the balance to later years as a short-term loss. |
| **Long-term gain only** | Long-term gain is taxed at 0% if the person is in a 10% or 15% tax bracket, 20% if the person is in the top tax bracket, and 15% for all other tax brackets. An additional 3.8% NIIT Medicare tax may apply. |
| **Long-term loss only** | You can deduct up to $3,000 ($1,500 if married and filing separately) against other income and carry over the balance to later years as a long-term loss. |

However, most investors will have a combination of short-term and long-term gains and losses, particularly if they are investing in the stock market. When that happens, gains and losses must be netted against each other in the following manner:

**Step 1:** **Sort your realized gains and losses into long-term and short-term**.

**Step 2:** **Net your short-term capital gains and losses.** To do so, you subtract the purchase price (including commissions) from the sales proceeds (net of commission) for each security, and then total the results. This will leave you with a net short-term gain, a net short-term loss, or zero.

**Step 3:** **Net your long-term capital gains and losses**.

**Step 4:** **Compute the tax impact according to the following table.**

|  |  |
| --- | --- |
| **If you have:** | **How you are taxed:** |
| **Short-term gain AND Long-term gain** | Short-term gain is taxed at regular rates. The long-term gain is taxed at 20%, 15% or 0%. The NIIT may apply. |
| **Short-term gain AND Long-term loss** | Net the short-term gain and long-term loss.  If the result is a net short-term gain, it is taxed at ordinary income tax rates. An additional 3.8% NIIT may apply.  If the result is a net long-term loss, you may deduct up to $3,000 ($1,500 if married and filing separately) against other income and carry over any balance to later years as a long-term loss. |
| **Short-term loss AND Long-term gain** | Net the short-term loss and long-term gain.  If the result is a net short-term loss, you may deduct up to $3,000 ($1,500 if married and filing separately) against other income and carry over any balance to later years as a short-term loss.  If the result is a long-term gain, the net long-term gain is taxed at 20%, 15% or 0%. An additional 3.8% NIIT may apply. |
| **Short-term loss AND Long-term loss** | You can deduct up to $3,000 ($1,500 if married and filing separately) against other income. The short-term loss is applied first, then the long-term loss. Any unused losses carry over to later years and retain their character as a short-term or long-term loss. |

## Qualified Dividends and Capital Gain Tax Worksheet - Line 44

Most of your clients will have ordinary income, qualified dividends, and capital gains and losses. Since different rates are involved, just how is this all pulled together? You may also recall that earlier, when figuring gross income, we included capital gains and qualified dividends. That means that they are included in taxable income as well. How, then, do we now apply different tax rates when everything has been added together?

For many taxpayers who have qualified dividends and/or capital gains, this will be accomplished with the Qualified Dividends and Capital Gains Tax Worksheet – Line 44. More information is available at [IRS Forms and Publications](https://apps.irs.gov/app/picklist/list/formsPublications.html) (search for *Form 1040 Schedule D*).

The worksheet makes it possible to back out the qualified dividends and capital gains, thereby calculating the tax on them at their appropriate rates, and then calculating the tax on the balance according to the tax rate schedule for ordinary income.

What does this worksheet accomplish? No matter how high a taxpayer’s income, long-term capital gains will be taxed at long-term capital gain rates instead of ordinary income rates.

## The Kiddie Tax

The ***Kiddie Tax*** was developed by Congress to prevent parents from shifting unearned income to a child in a lower tax bracket. For example, without the Kiddie Tax, a parent could transfer stocks to a child, thereby having the dividends taxed at the child’s lower tax rate.

However, in 1986 Congress imposed what is known as the Kiddie Tax. In essence, the IRS can collect taxes on unearned income of a child at the parent’s higher tax rates if the amount of unearned income by the child exceeds certain thresholds.

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| --- |
| Unearned Income  ***Unearned income*** for Kiddie Tax purposes would include interest, dividends, copyright patent payments, and any other income not earned by the child. |

**Click on the key elements of the Kiddie Tax below to learn more.**

|  |
| --- |
| **19 years of age** |
| The Kiddie Tax applies to children who are under the age of ***19, or under age 24 if a full-time student*** on the last day of the tax year. |
| **Greater than $2,100** |
| For 2016, unearned income ***greater than $2,100*** will be taxed on the child’s income tax return, but at the parent’s highest marginal tax rate. |
| **Less than or equal to $2,100** |
| For 2016, unearned income ***less than or equal to $2,100*** will be taxed as follows on the child’s income tax return:   * The first $1,050 would not be taxed because $1,050 is the standard deduction for a child (assuming no earned income). * The next $1,050 would be taxed at the child’s tax rate of 10%.   **What if the Child Has *Earned* Income?**  Two things happen:   1. The child always pays taxes on earned income at his or her rate. ***The “Kiddie Tax” only applies to unearned income.*** 2. The child’s standard deduction is the greater of:   a. $1,050  OR  b. $350 + Earned Income, not to exceed the “single” standard deduction\*  *\* $6,300 (2016, as indexed)* |

DocumentationIcon_32px**Click the icon to view an example.**

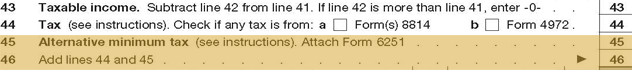
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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Kiddie Tax Example**  Jane, age 15, receives interest and dividends in 2016 from a trust set up by her grandparents. She also works in a local restaurant on a part-time basis and earns $7.00 per hour. Below are sample calculations of Jane’s taxable income, as well as the amount taxed at her rate and her parent’s rate assuming different amounts of earned and unearned income. Assume that Jane files her own income tax return.   |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | **2016-A** | **2016-B** | **2016-C** | **2016-D** | | Unearned Income | $2,500 | $ 550 | $2,100 | $3,200 | | Earned Income | 550 | 700 | 700 | $7,100 | | **Total Income:** | **$3,050** | **$1,250** | **$2,850** | **$10,300** | | Less Standard Deduction\*   |  | | --- | | Standard Deduction  Jane’s ***standard deduction*** is the greater of the standard deduction for a child ($1,050 in 2016) or $350 (2016) + earned income. Her total standard deduction cannot exceed the “single” standard deduction of $6,300 (2016). | | $ (1,050) | $(1,050) | $(1,050) | $(6,300) | | Personal exemption: | 0 | 0 | 0 | 0 | | Taxable Income: | **$2,000** | **$200** | **$1,800** | **$ 4,000** | | Taxed @ parents’ rate: Unearned income> $2,100: | **$400** | **$0** | **$0** | **$1,100** | | Taxed @ child’s rate: (Taxable Income – Unearned Income > $2,100) | **$1,600** | **$200** | **$1,800** | **$2,900** | |

## The Alternative Minimum Tax

Once the tentative tax has been calculated, it may also be necessary to compute the Alternative Minimum Tax. The ***Alternative Minimum Tax (AMT)*** is a separate income tax system that operates parallel to the regular income tax system. The original idea behind the tax was to prevent the wealthy from paying little or no income tax. Thus, its intent is to make sure each taxpayer pays some minimum level of income tax. It targets areas of tax preference and applies to individuals as well as trusts, estates and certain corporations.

Taxpayers who may be affected by the AMT must recalculate their tax under a different set of rules that treat some income and deductions differently from the regular income tax rules. This is accomplished by completing Form 6251, a copy of which can be viewed and printed by clicking here. .

If the resulting AMT calculation results in a higher tax calculation than the regular tax, then the taxpayer must pay the higher AMT amount by entering the increase on line 45 and adding it to the prior income tax calculation.



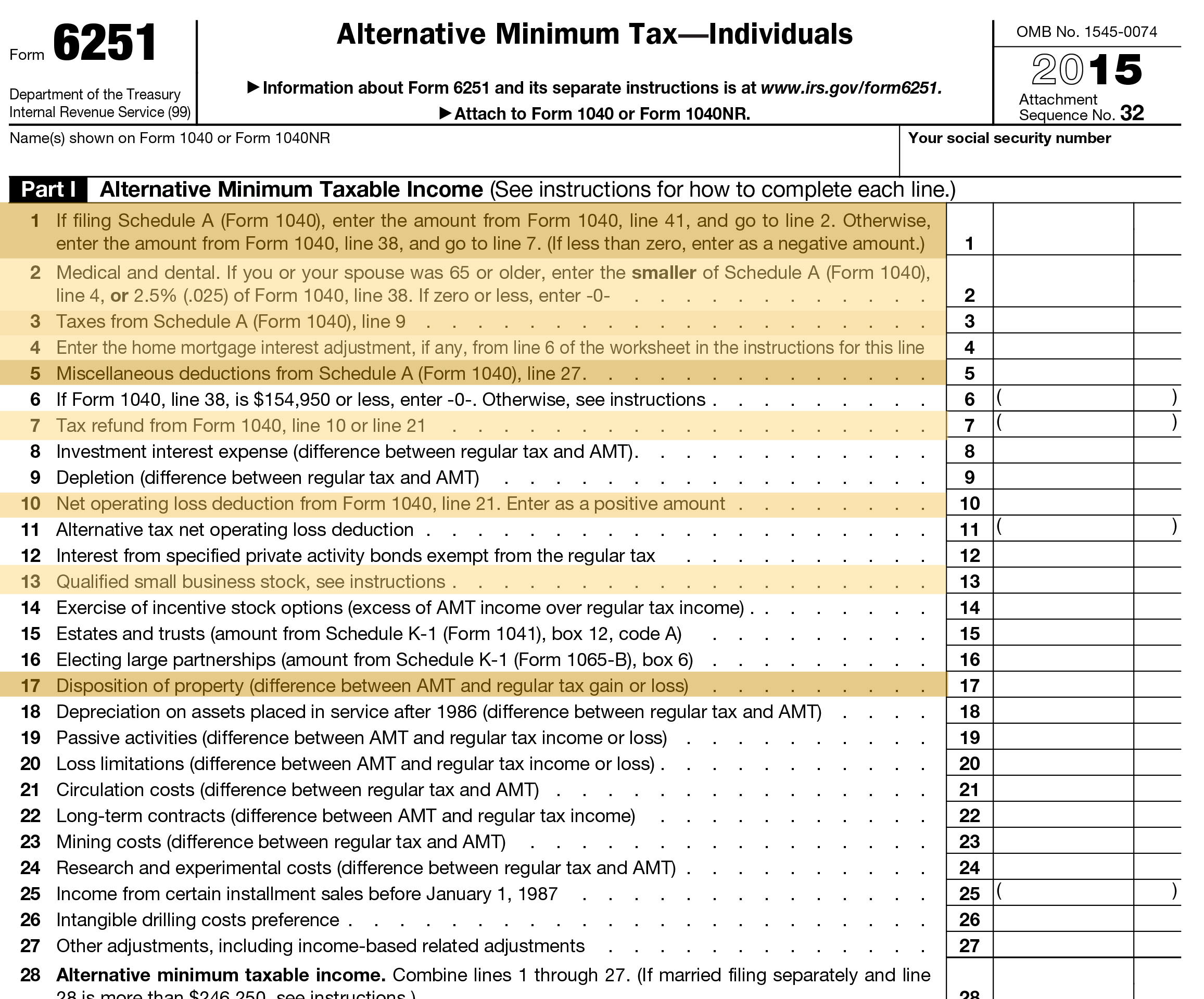
The American Taxpayer Relief Act of 2012 provided inflation indexing for the AMT at long last. In 2016, the AMT exemption amount for married filing jointly taxpayers was increased to $83,800, to $53,900 for single taxpayers, and to $41,900 for married filing separately taxpayers. The AMT exemption phases out above certain AGI thresholds.

## AMT Preference Items

The primary thing you need to know about the AMT calculation is that it does not use the same Taxable Income figure as was used in the regular income tax calculation. Rather, it makes a series of adjustments to income for what are deemed ***tax preference items***. These adjustments, which are typically added back to income, will likely result in an ***AMT Income (AMTI)*** that is higher than the one computed with the regular income tax calculation. Since the tax calculation is different, the fact that AMT Income may be higher than regular Taxable Income does not always result in a higher tax, but the likelihood of a higher tax increases if the adjustments are sizeable.

The first section of this Form 6251 is provided below. This is where adjustments are made for tax preference items to derive AMT Income, on which the alternative tax calculation will be made. Take a few minutes to read through the tax preference items in this section.We have highlighted the more common adjustments.

**Click the highlighted lines on the form to learn more.**



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| **Line 1**  The AMT calculation begins with AGI from Form 1040 if the standard deduction was used. If deductions were itemized on Schedule A, then the calculation begins with AGI minus the itemized deductions from Schedule A. The next few lines will make adjustments for some of those itemized deductions.  Note also that we are beginning with a number that has NOT been adjusted for personal exemptions; nor is there an adjustment for personal exemptions in deriving AMT income. Thus, we have effectively adjusted for personal exemptions by beginning with the amount entered in line 1. |

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| **Line 2**  This line, and the next few that follow, adjust for some of the deductions that were allowed when we itemized deductions on Schedule A. |

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| **Line 3**  Remember that when deductions were itemized on Schedule A, we were allowed to deduct ***state income taxes, real estate taxes, and property taxes***. Here we must add them back. |

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| **Line 4**  Certain interest on a home mortgage not used to buy, build, or improve your home (or a second home that is a qualified dwelling) must be added back. There may also be an adjustment if the home was refinanced. |

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| **Line 5**  The ***miscellaneous deductions*** from Schedule A get added back. |

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| **Line 7**  Here is one place where the taxpayer gets to reduce AMT income, whereas all the other adjustments under discussion generally result in increasing AMT income. If the taxpayer received a ***tax refund*** from the prior year on state or local taxes that had to be added into the calculation of regular taxes, the refund gets subtracted as an adjustment for AMT income. |

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| **Line 10**  Interest earned on municipal bonds is exempt from regular income taxes. However, for AMT purposes, a distinction is made between those municipal bonds that are issued for pure governmental functions and those that are issued for “private activity” issuers such as airports and certain types of housing agencies. These “private activity” municipal bonds, if issued after August 7, 1986, are included in the calculation of AMT income - unless issued by a 501(c)(3) organization.  Section 501(c)(3) of the Internal Revenue code identifies certain nonprofit organizations that are generally identified as existing for religious, charitable, or educational purposes. |

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| **Line 13**  ***Incentive stock options (ISO)*** are options granted by an employer to employees that allow the employee to purchase stock in the corporation. For normal income tax purposes, the exercise of the option is not a taxable event; rather, taxation occurs when the stock is finally sold. However, the failure to tax upon exercise of the option is treated as a tax preference item for AMT purposes. Thus, the amount by which the FMV exceeds the exercise price on the date of exercise will be added to the AMT income in the year of exercise, provided the taxpayer’s exercise rights are not subjected to a substantial risk of forfeiture. |

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| **Line 17**  If a taxpayer, for regular tax purposes, depreciates real property using accelerated ***depreciation methodologies***, then the depreciation may have to be recomputed using less aggressive methodologies. This may be an issue for business owners. |

## Tax Credits

Once the Tentative Tax is identified, with or without an adjustment for AMT, the final step is to reduce the Tentative Tax by any available credits. A ***tax credit*** is a dollar-for-dollar reduction in the taxpayer’s tax liability. To put tax credits in perspective, they are often spoken of in terms of their deductible equivalent. For example, for an individual in the 33% tax bracket, a $1 tax credit is equivalent to a $3 tax deduction. There are two types of tax credits: refundable and non- refundable income.

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| **Basic Tax Formula**  **Gross Income**  Less adjustments for Adjusted Gross Income  (AGI)  **Adjusted Gross Income (AGI)**  Less the greater of:  a) Standard deduction or  b) Total itemized deductions  Less Personal and Dependency Exemption(s)  **Taxable Income**  Multiplied by personal tax rate  Adjusted for Alternative Minimum Tax (AMT)  **Tentative Tax**  **Less tax credits**  Plus other taxes  **Equals Income Tax Liability** |

**Click each type to learn more.**

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| **Refundable Income** |
| A refundable tax credit is basically a guaranteed tax credit. Even if the taxpayer’s total tax liability is zero, refundable tax credits are still applicable. Therefore, a taxpayer with a tax bill of $300 and refundable credits totaling $500 will get a $200 refund. Examples of refundable tax credits include Earned Income Tax Credit and Health Coverage Tax Credit. |
| **Non-Refundable Income** |
| A non-refundable tax credit is a credit that cannot be used to reduce a taxpayer’s total tax liability to less than zero. |

Below is a list of the more common tax credits. Many of these will not apply to your typical client, as they only apply to low-income taxpayers. However, you should probably be familiar with all of them because you will see frequent mention of them in the news and you need to distinguish from among them those that are most likely relevant to your clients. **Click each credit to learn more.**

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| **Refundable Tax Credits** | **Non-refundable Tax Credits** |
| * Earned Income Tax Credit * Premium Tax Credit | * Child and Dependent Care Credit * Child Tax Credit * Credit for the Elderly or the Disabled * Foreign Tax Credit * Work Opportunity Tax Credit * Adoption Expense Credit |

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| **Earned Income Credit**  The ***Earned Income Tax Credit*** is a federal income tax credit for low-income taxpayers. It is a **refundable** credit that supplements the wages of low-income working families and individuals by reducing the amount of tax an individual owes. |

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| **Premium Tax Credit**  The Affordable Care Act of 2010 (the Act) established the Health Insurance Marketplace. The purpose of the Health Insurance Marketplace is to provide uninsured Americans an opportunity to purchase health insurance as required by the Act. Beginning in 2016, the premiums paid for policies purchased from the Health Insurance Marketplace may qualify for the ***Premium Tax Credit.*** This credit is a refundable federal income tax credit for qualifying moderate-income taxpayers. |

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| **Child and Dependent Care Credit**  The ***Child and Dependent Care Credit*** is a **non-refundable** tax credit that may reduce the tax liability of individuals who, in order to become gainfully employed, have to pay for child or dependent care services. This credit is available for use by taxpayers at all levels of income. |

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| **Child Tax Credit**  The Child Tax Credit is generally a non-refundable tax credit offered to qualifying taxpayers with dependent children, phased out at certain income levels. The tax credit is limited to $1,000. The credit is subject to phase-out when the taxpayer’s income reaches specified levels. To claim the credit, the child must:   * Be under age 17 at year end   AND   * The dependent must be a U.S. citizen or resident, and a blood or adoptive son, daughter, stepchild, or grandchild. Foster children qualify if they lived with the taxpayer as a member of the taxpayer’s household for all of the preceding year |

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| **Credit for the Elderly or the Disabled**  The ***Credit for the*** ***Elderly or the Disabled*** is a **non-refundable** credit for low-income taxpayers 65 or over, or retired on permanent and total disability. |

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| **Foreign Tax Credit**  The ***Foreign Tax Credit*** is a **non-refundable** credit that allows U.S. taxpayers to take a credit against income for foreign taxes paid to foreign countries or U.S. territories. It is intended to reduce the double tax burden that would otherwise arise when foreign sources of income are taxed by both the foreign country and the U.S.  Taxpayers can actually choose to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction.  The most likely place taxpayers will see foreign taxes being paid is on a mutual fund. Amounts paid or incurred will show up on the 1099 of the mutual fund as foreign taxes paid. |

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| **Work Opportunity Tax Credit (WOTC)**  The WOTC provides an incentive for employers to hire from targeted groups. An employer may receive a **nonrefundable** income tax credit of up to $9,600 for each unemployed individual hired from among the following groups:   * Long-term unemployed individuals * Veterans * Recipients of public assistance * Individuals with disabilities * Residents of economically depressed areas * Ex-felons within a year of release   The WOTC expired on December 31, 2013, and was renewed in late 2014 for 2014 income tax returns - the credit expired yet again for tax years beginning on or after January 1, 2015. The credit was renewed for five years by the PATH act of December 2015. |

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| **Adoption Expense Credit**  The **Adoption Expense Credit** is generally a **non-refundable credit** available for taxpayers incurring expenses in the adoption of a child. The amount of the credit is limited to $13,460 (2016, as indexed). The credit is phased out in 2016 for taxpayers with modified AGI between $201,920 and $241,920 (2016, as indexed).  You should be aware that there is also an **adoption expense exclusion**, which is different than the credit. The adoption exclusion allows taxpayers to exclude from taxable income amounts paid or reimbursed by their employer for adoptions. The maximum exclusion amount equals the maximum credit amount.  Keep in mind that a taxpayer may use both the adoption credit and the exclusion. However, any expenses that are reimbursed by the employer will not be available for use in computing the adoption expense credit.   |  | | --- | | **Example 1**  Jim and Joy pay $19,000 of qualifying adoption expenses in 2016 to adopt Monica. Jim’s employer reimbursed him for $5,000 of the expenses. They have $14,000 in adoption expenses eligible for the adoption credit ($19,000-$5,000). They will be able to exclude $5,000 from taxable income and take a credit for $13,460 on their 2016 tax return. |  |  | | --- | | **Example 2**  Roy and Kim pay $10,000 of qualifying adoption expenses in 2016 to adopt Robert. Kim’s employer reimbursed her for $4,000 of the expenses. They have $6,000 in adoption expenses eligible for the adoption credit ($10,000-$4,000). They will be able to exclude $4,000 from taxable income and take a credit for $6,000 on their 2016 tax return. |  |  | | --- | | **Example 3**  Brian and Katy pay $30,000 of qualifying adoption expenses in 2016 to adopt Gavin. Katy’s employer reimbursed her for $13,460 of the expenses. They have $16,540 in adoption expenses eligible for the adoption credit ($30,000-$13,460). They will be able to exclude $13,460 from taxable income and take a credit for $13,460 on their 2016 tax return. | |

## Review Exercise

**For questions 1- 5, refer to our previous discussion of “Calculation of Capital Gains Taxes” in this course for a brief refresher.**

1. **Bruce purchased 100 shares of American Industries five years ago at $8.00 per share and sold them in the current year for $24.00 per share. The commission on each transaction was $25. This is his only capital transaction for the current year, he has no loss carry-forward that he could use from the prior year, and he is not subject to the 3.8% Net Investment Income Tax. Bruce is in the 28% ordinary income tax bracket. What is the tax impact of his transaction in the current year?**

* A short-term gain of $1,600, taxed at his marginal tax rate.

**Incorrect.** Since it was held for over a year, this is a long-term gain. Also, the commissions must be accounted for in computing the gain. Try again.

* A long-term gain of $1,550, taxed at his marginal tax rate.

**Incorrect.** Since it is a long-term gain, it is not taxed at his marginal rate. Try again.

* **A long-term gain of $1,550, taxed at 15%.**

**Correct.** As a long-term gain, it is taxed at the long-term capital gain rate of 15%. His basis in the shares is $825 calculated as 100 shares @ $8/share plus the commission of $25. His net sales price is $2,375 calculated as 100 shares @ $24/share less $25 commission.

* A long-term gain of $1,550, taxed at 0%.

**Incorrect.** His AGI is too high for him to qualify for the lower capital gains tax rate. Try again.

1. **Continuing with Bruce’s situation, suppose that he had the following additional gains and losses in the current year:**

**$300 long-term loss (net of commissions) on ABC Inc.**

**$800 short-term gain (net of commissions) on XYZ Inc.**

**$1,000 short-term loss (net of commissions) on A2Z Inc.**

**What is the net gain/loss on which his capital gains tax will be computed?**

* A $200 loss against ordinary income and a net long-term gain of $1,250 (taxed at 15%)

**Incorrect.** The $200 net short-term loss must be netted against the net long-term gain. Try again.

* A $1,300 loss against ordinary income; a short-term gain of $800 (taxed at ordinary rates), and a long-term gain of $1,550 (taxed at 15%)

**Incorrect.** The short-term gains and losses must be netted against each other; then the long-term gains and losses must be netted against each other. Try again.

* **A net long-term gain of $1,050, taxed at 15%**

**Correct.** His net short-term position is a $200 loss ($800 - $1,000). His net long-term position is a $1,250 gain ($1,550 - $300). Netting the two together, he is left with a net long-term gain of $1,050.

1. **Building upon the preceding question, now suppose Bruce had a net long-term capital loss last year of $10,000 and used $3,000 of that loss against ordinary income last year. What would be his tax bill for his current year transactions?**

* $157.50 (15% of his net long-term gain of $1,050) on his net long-term gain

**Incorrect.** Last year, Bruce would have deducted $3,000 against ordinary income and carried forward the remaining long-term loss of $7,000. Thus, in the current year, he would end up with a net short-term loss of $200 and a net long-term loss of $5,750. Starting with the short-term loss, then the long-term loss, he would take a $3,000 deduction against ordinary income, and then carry forward the remaining $2,950 of long-term loss.

* $157.50 on his net long-term gain and a $3,000 deduction against ordinary income

**Incorrect**. Last year, Bruce would have deducted $3,000 against ordinary income and carried forward the remaining long-term loss of $7,000. Thus, in the current year, he would end up with a net short-term loss of $200 and a net long-term loss of $5,750. Starting with the short-term loss, then the long-term loss, he would take a $3,000 deduction against ordinary income, and then carry forward the remaining $2,950 of long-term loss.

**A $3,000 deduction against ordinary income**

**Correct!** Last year, Bruce would have deducted $3,000 against ordinary income and carried forward the remaining long-term loss of $7,000. Thus, in the current year, he would end up with a net short-term loss of $200 and a net long-term loss of $5,750. Starting with the short-term loss, then the long-term loss, he would take a $3,000 deduction against ordinary income, and then carry forward the remaining $2,950 of long-term loss.

1. **Alice has the following transactions in the current year, net of commissions.**

**Short-term loss of $500**

**Short-term gain of $1,000**

**Long-term loss of $800**

**Long-term gain of $1,600**

**Assuming she has no loss carry forward and that she is at a marginal tax rate of 28%, what is the tax impact of her gains and losses?**

* **A short-term gain of $500 (taxed as ordinary income) and a long-term gain of $800 (taxed at 15%)**

**Correct.** If you have both a net short-term capital gain and a net long-term capital gain, the short-term gain is taxed as ordinary income and the long-term gain is taxed at the long-term capital gain rate.

* A net gain of $1,300 (taxed as ordinary income)

**Incorrect.** If you have both a net short-term capital gain and a net long-term capital gain, the short-term gain is taxed as ordinary income and the long-term gain is taxed at the long-term capital gain rate.

* A net gain of $1,300 (taxed at 15%)

**Incorrect.** If you have both a net short-term capital gain and a net long-term capital gain, the short-term gain is taxed as ordinary income and the long-term gain is taxed at the long-term capital gain rate.

* A short-term gain of $500 (taxed as ordinary income) and carry forward the long-term gain of $800.

**Incorrect.** If you have both a net short-term capital gain and a net long-term capital gain, the short-term gain is taxed as ordinary income and the long-term gain is taxed at the long-term capital gain rate.

1. **Seven years ago, Susan purchased 100 shares of XYZ stock for $1,000. She sold the shares for $600 on May 1 of the current year. Over the next two weeks, the price fell significantly and Susan decided the stock could only go up from there, so she bought back 100 shares of XYZ stock for $300 on May 15 of the current year. Four weeks later, the stock price increased to $400 per share, so she sold the 100 shares for $400. What is her gain or loss on the final sale?**

* $100 short-term gain

**Incorrect.** Because this is a wash sale, Susan’s loss of $400 per share on the first sale must be added to the basis of the repurchase, making the adjusted basis $700 per share. When she subsequently sells for $400, she realizes a $300 loss. Furthermore, since she must also use the holding period that began with her first purchase, this loss is long-term.

* $300 short-term loss

Incorrect. Because this is a wash sale, Susan’s loss of $400 per share on the first sale must be added to the basis of the repurchase, making the adjusted basis $700 per share. When she subsequently sells for $400, she realizes a $300 loss. Furthermore, since she must also use the holding period that began with her first purchase, this loss is long-term.

* **$300 long-term loss**

**Correct!** Because this is a wash sale, Susan’s loss of $400 per share on the first sale must be added to the basis of the repurchase, making the adjusted basis $700 per share. When she subsequently sells for $400, she realizes a $300 loss. Furthermore, since she must also use the holding period that began with her first purchase, this loss is long-term.

* $400 short-term loss

**Incorrect.** Because this is a wash sale, Susan’s loss of $400 per share on the first sale must be added to the basis of the repurchase, making the adjusted basis $700 per share. When she subsequently sells for $400, she realizes a $300 loss. Furthermore, since she must also use the holding period that began with her first purchase, this loss is long-term.

* $400 long-term loss

Because this is a wash sale, Susan’s loss of $400 per share on the first sale must be added to the basis of the repurchase, making the adjusted basis $700 per share. When she subsequently sells for $400, she realizes a $300 loss. Furthermore, since she must also use the holding period that began with her first purchase, this loss is long-term.

1. **In 2016, a taxpayer‘s child is 16 years of age and earns $1,200 per year delivering a community newspaper in the neighborhood. In addition, the child has $2,100 of interest income. How much is subject to the Kiddie Tax?**

* **$0**

**Correct!** Only unearned income that exceeds $2,100 is subject to the Kiddie Tax in 2016.

* $1,200

**Incorrect.** Only unearned income that exceeds $2,100 is subject to the Kiddie Tax in 2016. Try again.

* $2,000

**Incorrect.** Only unearned income that exceeds $2,100 is subject to the kiddie Tax in 2016. Try again.

* $3,200

**Incorrect.** Only unearned income that exceeds $2,100 is subject to the Kiddie Tax in 2016. Try again.

1. **Which of the following are adjusted for in deriving AMT income?**

**1. Personal exemptions**

**2. Tax-exempt interest on certain private activity bonds**

**3. Exercise of Incentive Stock Options**

* 1 only

**Incorrect.** This is not the only adjustment item listed.

* 2 only

**Incorrect.** This is not the only adjustment item listed.

* 3 only

**Incorrect.** This is not the only adjustment item listed.

* 2 and 3 only

**Incorrect.** All three are adjustment items.

* **1, 2, and 3**

**Correct!** All three are adjustment items.

1. **Tax credits are dollar-for-dollar reductions of a taxpayer’s tax liability.**

* **True**

**Correct!**

* False

**Incorrect.**

1. **Which of the following credits is available to persons at every level of income?**

* Earned Income Tax Credit

Incorrect. The EITC is available only for low-income taxpayers.

* Credit for the Elderly or Disabled

**Incorrect.** Qualifying individuals for the Elderly or Disabled Credit must have adjusted gross income below relatively low levels.

* Adoption Expense Credit

**Incorrect.** While high, the Adoption expense credit is limited to taxpayers below certain levels of AGI.

* **Child and Dependent Care Credit**

**Correct!** The Child and Dependent Care Credit is available to taxpayers of all income levels.

## Conclusion

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study.