

CHAPTER *12*

**Planning Your
Tax Strategy**



Chapter 12

Planning Your Tax Strategy

What You'll Learn

- **Section 12.1**
 - Discuss the importance of tax planning.
 - Identify your taxable income.
 - Explain deductions and tax credits.
 - Explain the W-4 form.
- **Section 12.2**
 - Describe the types of federal income tax forms.
- **Section 12.3**
 - Identify tax strategies.

Electronic Taxes

- **Q:** I would like to file my income tax form electronically. Is it risky to file through the Internet?
- **A:** If you are concerned about being charged late penalties if your tax return is not received by the IRS via the Internet, you can protect yourself by using filing services that offer a receipt, such as a confirmation number or e-mail confirmation.

Go to finance07.glencoe.com to complete the Standard & Poor's Financial Focus activity.

Section 12.1

Income Tax Fundamentals

*Before
You Read*

PREDICT

Why would planning a tax strategy be a good idea?

Main Idea

Taxes are an important part of financial planning. There are several types of taxes and terms to know for preparing your tax return.

Section 12.1

Income Tax Fundamentals

Taxes and You

Taxes are an everyday expense of life that allow your local, state, and federal governments to provide important services.

These services include:

- Medicare and Medicaid
- The military and the national debt
- Police and fire protection
- Public schools
- Road maintenance
- Parks and libraries
- Safety inspection of foods, drugs, and other products

Section 12.1

Income Tax Fundamentals

tax liability

the total amount
of taxes owed

Effective Tax Planning

Effective tax planning can help you have money left after paying taxes and living expenses.

Use several strategies to plan for taxes:

- Find out how the current tax laws and regulations affect you.
- Maintain complete and accurate tax records.
- Learn how to make decisions that can reduce your **tax liability**.

Section 12.1

Income Tax Fundamentals

Types of Taxes

Throughout your life, you will pay different types of taxes in four major categories:

- Purchases
- Property
- Wealth
- Earnings

Section 12.1

Income Tax Fundamentals

Taxes on Purchases

Sales taxes are:

- Added to the prices of most products you purchase
- Collected by state and local governments

Many states do not charge sales tax on food and medicine.

Section 12.1

Income Tax Fundamentals

Taxes on Property

Real estate property tax is a major source of income for local governments. This tax is based on the value of land and buildings.

In some areas of the country, state and local governments may assess taxes on the value of property, such as:

- Automobiles
- Boats
- Furniture
- Farm equipment

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Income Tax Fundamentals

estate tax

a federal tax collected on the value of a person's property at the time of his or her death

inheritance tax

a state tax collected on the property left by a person to his or her heir(s) in a will

Taxes on Wealth

The three main types of federal taxes on wealth are:

- **Estate taxes**
- **Inheritance taxes**
- Gift taxes (collected on money or property valued at more than \$11,000, given by one person to another in a single year)

Gifts of any amount that are designated for educational or medical expenses are not subject to gift taxes.

Section 12.1

Income Tax Fundamentals

income tax

the tax on wages, salaries, and self-employed earnings

Taxes on Earnings

The personal **income tax** is the federal government's main source of revenue.

Social Security funds are also collected as a tax and finance:

- Retirement
- Disability
- Life insurance benefits

The Internal Revenue Service (IRS) is the federal agency that collects these taxes.

Section 12.1

Income Tax Fundamentals

income tax return

a form on which a taxpayer reports how much money he or she received from working and other sources, and the exact taxes that are owed

Understanding Income Taxes

You determine the amount of tax you owe when filling out your **income tax returns**. Some examples of these forms include:

- 1040
- 1040EZ

If the income tax you paid through your employer is greater than your tax liability, you will receive a refund.

Section 12.1

Income Tax Fundamentals

exclusion

income that is not
subject to taxes

Gross and Adjusted Gross Income

Gross income, or total income, can include any of the following components:

- Earned income
- Interest income
- Dividend income

Your gross income can also be affected by **exclusions**.

Section 12.1

Income Tax Fundamentals

adjusted gross income

your gross income
after calculating
certain reductions

Adjusted Gross Income

You pay income tax on your **adjusted gross income**, not on your gross income.

The reductions, or adjustments to your income, include items such as:

- Contributions to an IRA
- Student loan interest

The correct amount of your adjusted gross income is important because it is the basis for other tax calculations.

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Income Tax Fundamentals

taxable income

your adjusted gross income less any allowable tax deductions and exemptions

Your Taxable Income

When you determine your adjusted gross income, you can figure out your **taxable income**. Your income tax is calculated based on the amount of your taxable income.

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Income Tax Fundamentals

tax deduction

an expense that you can subtract from your adjusted gross income to figure your taxable income

itemized deduction

a specific expense that you deduct from your adjusted gross income

standard deduction

an amount of money set by the IRS that is not taxed

Tax Deductions

You may qualify for certain **tax deductions** that can reduce your taxable income. A few of the most common **itemized deductions** include:

- Medical and dental expenses
- Taxes
- Interest
- Contributions

Every taxpayer receives at least the **standard deduction**. If you qualify for both the standard and itemized deductions, you must choose which one to take.

Section 12.1

Income Tax Fundamentals

exemption

a deduction from adjusted gross income for the taxpayer, the spouse, and qualified dependents

Exemptions

You will also be able to receive tax deductions for your dependents. To qualify as a dependent, a person must meet all of the following requirements:

- A dependent must not earn more than a set amount unless he or she is under age 19 or is a full-time student under age 24.
- He or she must be a specified relative or live in the home of the taxpayer who claims him or her on the tax return.
- More than half of a dependent's support must be provided by the taxpayer who claims him or her on the tax return.

Section 12.1

Income Tax Fundamentals

tax credit

an amount of money that can be subtracted directly from taxes you owe

Calculating Your Tax

Once you know your taxable income, you can calculate how much income tax you owe by using a:

- Tax Table
- Tax Rate Schedule

Your income tax may be reduced by a **tax credit**.
A tax credit:

- Is an expense that you can subtract from your adjusted gross income
- Results in a dollar-for-dollar reduction in the amount of taxes you owe

Section 12.1

Income Tax Fundamentals

Making Tax Payments

You can pay your income taxes to the federal government through:

- Estimated payments
- Payroll withholding payments

People who are self-employed may pay estimated taxes each quarter.

Section 12.1

Income Tax Fundamentals

allowance

an adjustment to the tax withheld from your paycheck, based on your marital status and whether you have dependents

Payroll Withholding

To fill out a W-4 form, you need to:

- Fill in your name, address, and Social Security number.
- Indicate whether you are single or married.
- Write the number of **allowances** you are claiming.
- Indicate how much additional money you wish to have withheld.
- Sign and date the form.

An allowance can reduce the amount of income taxes your employer withholds, or deducts, from your paycheck to send to the IRS.

Section 12.1

Income Tax Fundamentals

Estimated Payments

If you are self-employed, you will need to make estimated payments to the government, based on your estimate of taxes due at the end of the year.

Section 12.1

Income Tax Fundamentals

Claiming Allowances

Claiming few or no allowances on your W-4 form is one way to:

- Get tax refunds from the government.
- Create a “forced savings account.”

Section 12.2

Preparing an Income Tax Return

*Before
You Read*

PREDICT

What factors might determine whether you have to file income taxes?

Main Idea

Special information and documents are needed to prepare income tax returns. You can choose one of three main federal tax return forms.

Section 12.2

Preparing an Income Tax Return

The W-2 Form

When it is time for you to file your annual income tax return, your employer will send you a W-2 form, or Wage and Tax Statement.

This form lists:

- Your annual earnings
- The amount withheld from your paychecks for federal income taxes, Social Security, and any applicable state and local income taxes

Section 12.2

Preparing an Income Tax Return

Understanding the Federal Income Tax Return

Before you begin filling out your income tax return, consider some basic information:

- Who must file
- Deadlines and penalties
- Tax forms

Section 12.2

Preparing an Income Tax Return

Who Must File?

You are required to file a federal income tax return if:

- Your income is above a certain amount.
- You are a citizen or a resident of the United States.
- You are a U.S. citizen who resides in Puerto Rico.

The amount of your income tax return is based on your filing status and other factors, such as your age.

Section 12.2

Preparing an Income Tax Return

Filing Status Categories

The five filing status categories are:

- Single
- Married, filing a joint return
- Married, filing separate returns
- Head of household
- Qualifying widow or widower

Section 12.2

Preparing an Income Tax Return

extension

an extended deadline for filing an income tax return

Deadlines and Penalties

If you cannot meet the April 15th income tax return deadline, you can file a form by that date to receive a four-month **extension**.

Failing to file a required tax return:

- Is a serious violation of the tax code
- Can result in a substantial penalty

Section 12.2

Preparing an Income Tax Return

Choosing the Tax Form

The IRS offers about 400 tax forms and schedules. However, you have a choice of three basic forms:

- Form 1040EZ
- Form 1040A
- Form 1040

Form 1040 is an expanded version of Form 1040A.

Section 12.2

Preparing an Income Tax Return

Form 1040EZ

Form 1040EZ is the simplest tax form to complete. You may use this form if:

- Your taxable income is less than \$100,000.
- You are under age 65.
- You claim no dependents.
- Your income consisted of only wages, salaries, and tips, and no more than \$1,500 of taxable interest.
- You will not itemize deductions, claim any adjustments to income, or claim any tax credits.

Section 12.2

Preparing an Income Tax Return

Completing the Federal Income Tax Return

Filling out a federal income tax return does not have to be difficult as long as you:

- Are prepared
- Have the correct documents and information
- Understand the form you are using

Make a rough draft of your tax return before you complete a final draft.

Section 12.2

Preparing an Income Tax Return

Gathering Information and Documents

Being prepared at tax time means you have all the necessary documents.

The following checklist of documents will help you complete a successful tax return:

- Tax forms and instruction booklets
- Copies of your tax returns
- Your W-2 form
- Interest and dividend forms

Section 12.2

Preparing an Income Tax Return

Completing the Form 1040EZ

To complete Form 1040EZ:

- Print your name, address, and Social Security number.
- Enter the total wages from your W-2 form.
- Enter the amount of interest from your savings account.
- Enter the amount of income tax that was withheld from your paychecks.
- Sign and date your income tax return.
- Enter your occupation.

Section 12.2

Preparing an Income Tax Return

Completing the Form 1040A

Some taxpayers benefit from using Form 1040A. This form enables taxpayers to claim deductions that will reduce the amount of tax they must pay.

Section 12.2

Preparing an Income Tax Return

Filing Your Federal Income Tax Return

You have several ways to file your federal income tax return:

- Fill out the forms and mail them to the IRS.
- Use an authorized IRS E-file provider to transmit your return directly to an IRS computer.
- Use your personal computer and tax software to prepare your own tax return via E-file.

Section 12.2

Preparing an Income Tax Return

Completing State Income Tax Returns

The seven states that do not have a state income tax are:

- Alaska
- Florida
- Nevada
- South Dakota
- Texas
- Washington
- Wyoming

States usually require their income tax returns to be filed at the same time as federal income tax returns.

Section 12.3

Tax Assistance and Strategies

*Before
You Read*



PREDICT

Who do you think is an appropriate professional to hire for preparing your taxes?

Main Idea

As your income and investments increase and your personal life changes, preparing your taxes may become more complex.

Section 12.3

Tax Assistance and Strategies

Tax Assistance

When your tax preparation becomes complicated, you can find assistance through:

- Professionals and agencies
- A variety of software programs for tax preparation
- How-to books about tax planning and completing tax forms
- Personal finance magazines
- The IRS Web site

Section 12.3

Tax Assistance and Strategies

tax audit

a detailed examination of your tax return by the IRS

Tax Audits

The IRS reviews all tax returns for completeness and accuracy.

If your math is incorrect, the IRS may:

- Reconfigure your tax return and send you either a bill or a refund
- Audit your tax return and request additional information

The IRS does periodic **tax audits** to determine whether taxpayers are paying all of their required taxes.

Section 12.3

Tax Assistance and Strategies

Planning Tax Strategies

Smart taxpayers know how to legally minimize the amount of tax they have to pay.

You can reduce the amount of tax you owe by using various strategies related to:

- Purchases
- Investments
- Retirement

Section 12.3

Tax Assistance and Strategies

Consumer Purchasing Strategies

The buying decisions you make can affect the amount of taxes you pay. For example, if you purchase a house:

- The interest you pay on your mortgage and your real estate property taxes are deductible.
- You can deduct the interest on a home equity loan.

Some job-related expenses may also be deducted.

Section 12.3

Tax Assistance and Strategies

Investment Decisions

Certain investment decisions may:

- Reduce your income tax
- Increase your income
- Lower your taxes

For example, the interest on municipal bonds is not usually taxed.

Other investments may be tax-deferred, which means that the income is taxed at a later date.



Try Layaway

Some stores offer layaway plans. If you want to buy that special dress, pair of pants, or coat, ask the store about its layaway plan. You make installment payments and get the item when the last payment is made. This is a no-interest way of paying that does not require a credit card.

If you want to buy a pair of skis that costs \$240, how long will you make monthly payments of \$30?

Section 12.3

Tax Assistance and Strategies

Retirement Plans

Now is the time to start planning for your retirement.

To encourage early planning, the government allows you to defer paying taxes on money that you invest in retirement plans.

Section 12.3

Tax Assistance and Strategies

Changing Your Tax Strategy

Since tax laws are always changing, your tax strategies should change too.

As the government allows new deductions or as deductible amounts change, you should review your financial plans to always take full advantage of new tax laws that may reduce the amount you pay.

Chapter 12

Planning Your Tax Strategy

Key Term Review

- tax liability
- estate tax
- inheritance tax
- income tax
- income tax return
- exclusion
- adjusted gross income
- taxable income
- tax deduction
- standard deduction
- itemized deduction
- exemption
- tax credit
- allowance
- extension
- tax audit

Chapter 12

Planning Your Tax Strategy

Reviewing Key Concepts

1. Describe how taxes have an impact on financial planning.

Financial planning involves taxes because they reduce your take home pay. Other financial decisions also affect the amount of taxes you pay.

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Planning Your Tax Strategy

Reviewing Key Concepts

2. Explain how you determine your adjusted gross income and taxable income.

Adjusted gross income is your gross income after calculating certain reductions.

These reductions, or adjustments to your income, include items such as:

- Contributions to an IRA
- Student loan interest

Your taxable income is earned income plus interest and dividend income minus exclusions, deductions, and exemptions.

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Planning Your Tax Strategy

Reviewing Key Concepts

3. Describe why you should itemize deductions as opposed to taking the standard deduction.

You should itemize deductions if this total is greater than the standard deduction.

A few of the most common itemized deductions include:

- Medical and dental expenses
- Taxes
- Interest
- Contributions

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Planning Your Tax Strategy

Reviewing Key Concepts

4. Identify the factors to consider when filling out the W-4 form for your employer.

To fill out a W-4 form, you need to:

- Indicate whether you are single or married.
- Write the number of allowances you are claiming.
- Indicate how much additional money you wish to have withheld.
- Determine whether you are exempt from paying income tax.

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Planning Your Tax Strategy

Reviewing Key Concepts

5. Describe the 1040EZ, 1040A, and 1040 income tax forms.

Form 1040EZ is for filers with:

- No dependents
- Less than a certain amount in taxable income

Form 1040A allows filers to claim deductions for:

- IRA contributions
- Tax credits

Form 1040 must be filed if you are:

- Itemizing deductions
- Have more than a certain amount in taxable income

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Planning Your Tax Strategy

Reviewing Key Concepts

6. List some tax advantages of retirement investing.

To encourage early planning, the government allows you to defer paying taxes on money that you invest in retirement plans.

Newsclip: Tax Checkup

Tax laws can change each year. Knowing the new rules can help you save money.

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