



Federal Income Tax Base

by Sophia



WHAT'S COVERED

In this lesson, you will learn how to calculate taxable income. You will explore the various digital tools available to you. You will also learn the importance of not procrastinating to ensure you can be as productive as possible. Specifically, this lesson will cover:

1. Overview of Federal Income Tax Returns

Nearly every adult must complete and file a federal income **tax return** each year before mid-April. A tax return is information that a taxpayer compiles and reports to the IRS on a standardized form. Sounds simple, right? Consider the form shown below. For some, completing this form is simple. But for others, the tax return process may seem very complicated.

Form 1040 Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space. **Draft**

Filing status: ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial Last name Your social security number

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial Last name Spouse's social security number

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☐ Full-year health care coverage or exempt (see inst.)

☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Presidential Election Campaign (see inst.) ☐ You ☐ Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. If more than four dependents, see inst. and ✓ here ▶ ☐

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit Credit for other dependents

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature Date Your occupation If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Spouse's signature. If a joint return, **both** must sign. Date Spouse's occupation If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

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Preparer's name Preparer's signature PTIN Firm's EIN Check if:
☐ 3rd Party Designee
☐ Self-employed

Firm's name ▶ Phone no.

Firm's address ▶

Attach Form(s) W-2. Also attach Form(s) W-2S and 1099-R if tax was withheld.

Standard Deduction for—
• Single or married filing separately, \$12,000
• Married filing jointly or Qualifying widow(er), \$24,000
• Head of household, \$18,000
• If you checked any box under Standard deduction, see instructions.

1	Wages, salaries, tips, etc. Attach Form(s) W-2	1	
2a	Tax-exempt interest	2a	
3a	Qualified dividends	3a	
4a	IRAs, pensions, and annuities	4a	
5a	Social security benefits	5a	
6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22	6	
7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6	7	
8	Standard deduction or itemized deductions (from Schedule A)	8	
9	Qualified business income deduction (see instructions)	9	
10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-	10	
11	a Tax (see inst.) (check if any from: 1 <input type="checkbox"/> Form(s) 8814 2 <input type="checkbox"/> Form 4972 3 <input type="checkbox"/>)	11	
12	b Add any amount from Schedule 2 and check here	12	
13	a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here ▶ <input type="checkbox"/>	13	
14	Subtract line 12 from line 11. If zero or less, enter -0-	14	
15	Other taxes. Attach Schedule 4	15	
16	Total tax. Add lines 13 and 14	16	
17	Federal income tax withheld from Forms W-2 and 1099	17	
18	Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863	18	
19	Add any amount from Schedule 5	19	
20a	Amount of line 19 you want refunded to you. If Form 8888 is attached, check here ▶ <input type="checkbox"/>	20a	
21	Amount of line 19 you want applied to your 2019 estimated tax ▶	21	
22	Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions ▶	22	
23	Estimated tax penalty (see instructions) ▶	23	

Form 1040



When returns are more complex, people may choose to work with an accountant. Like many professionals responsible for continually meeting deadlines, accountants also have to manage stress and prevent procrastination to stay successful. And they must prioritize their tasks to stay focused on the most important assignments first. Accountants couldn't do any of it without practicing their productivity skill each and every day. It's what allows them to strategize, organize, and plan so they can perform their best.

TERM TO KNOW

Tax Return

Information that a taxpayer compiles and reports to the IRS on a standardized form.

1a. The Tax Return Process

Employers, banks, investment companies, and businesses all report income and expense information about you to the IRS. When you send your tax return to the IRS, it is compared against this other information already submitted. If there are differences, the IRS may choose to contact you.



What has been your experience with your taxes? Do you dread doing them? Do you use an accountant to help? No matter how you feel about taxes or filing them, if you want to make sure you are being productive and doing all you can to secure your financial future, you need to have a plan and execute it.

1b. Tax Formula

In this topic, we will guide you through the filing process and identify planning strategies that will help to minimize your tax base or tax rate. The first step is understanding the tax formula.



Knowing how income taxes work will empower you to be proactive in finding legal ways to minimize the taxes you must pay while maximizing your after-tax wealth. One of the best ways to gain this knowledge is by completing a tax form.

The following illustration shows the federal income tax formula that is captured in Form 1040.

- Once you calculate your tax base, you will likely need to use more than one tax rate to calculate your total taxes.
- Once you know the amount of your taxes, you may be able to reduce your tax liability (if any) by claiming a credit against the amount you owe.

Gross income

- **Deductions for adjusted gross income**
- = **Adjusted gross income**
- **Deductions from adjusted gross income**
- = **Taxable income (tax base)**
- × **Tax rate(s) multiplied by taxable income**
- = **Assessed income tax**
- + **Other taxes and penalties**
- **Credits and withholdings**
- = **Net tax due (or refund)**






By learning to effectively track your income and strategize for tax season, you can gain an understanding of your personal finances, which will pay off by freeing up more of your time and hard-earned money in the future.

2. Entering Personal Information

The first step when beginning to work on your taxes is to enter your personal information (i.e., name, address, and Social Security number). Next, you will need to determine your filing status and presence of dependents in your household.

2a. Filing Status

Filing status is determined by your marital status and the presence of dependents. There are two categories of dependents: (1) qualifying children and (2) qualifying relatives. The IRS uses five filing statuses, as shown in the illustration below.

	Single <ul style="list-style-type: none"> • Not married. • No dependent children or relatives.
	Married Filing Jointly <ul style="list-style-type: none"> • Must be legally married on the last day of the year (December 31).
	Married Filing Separately <ul style="list-style-type: none"> • Must be legally married on the last day of the tax year and choose to file separately.
	Head of Household <ul style="list-style-type: none"> • Not married. • Support at least one qualifying dependent.
	Qualifying Widow(er) <ul style="list-style-type: none"> • Spouse died within the three previous years and has not remarried. • Support at least one qualifying child. • In the year of death, surviving spouse files as married filing jointly or married filing separately.

➔ **EXAMPLE** Let's consider Jeff and Maria's situation.

- Jeff and Maria are both 24 years old and recently married (on December 21).
- Jeff earns \$27,000 and Maria earns \$35,000; they earned \$125 in interest on their savings account for the year.
- They have no children or other dependents.

Even though they were married near the end of the year, Jeff and Maria's filing status can be either married filing jointly or married filing separately. In their case, Jeff and Maria have decided to file a joint tax return.

Jeff and Maria use Form 1040 to file their tax return. Although Jeff and Maria may use free tax preparation software to prepare their tax return, the underlying form that they are using is still Form 1040. You can see Jeff and Maria's tax return below.

Form 1040 Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space. **Draft**

Filing status: ☐ Single ☒ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial: **Jeff** Last name: **Sample** Your social security number: **0 0 0 | 0 0 | 0 1 2 3**

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial: **Maria** Last name: **Sample** Spouse's social security number: **0 0 0 | 0 0 | 0 9 9 4**

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☒ Full-year health care coverage or exempt (see inst.)

☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. **1234 South Street** Apt. no. **Presidential Election Campaign (see inst.)** ☐ You ☐ Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. **Anytown, GA 30000** If more than four dependents, see inst. and ✓ here ☐

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature: **Jeff Sample** Date: **1/31/2021** Your occupation: **Writer** If the IRS sent you an Identity Protection PIN, enter it here (see inst.):

Spouse's signature. If a joint return, both must sign. **Maria Sample** Date: Spouse's occupation: **Lab Assistant** If the IRS sent you an Identity Protection PIN, enter it here (see inst.):

Paid Preparer Use Only

Preparer's name: Preparer's signature: PTIN: Firm's EIN: Check if: ☐ 3rd Party Designee ☐ Self-employed

Firm's name: Phone no.:

Firm's address:

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.

1	Wages, salaries, tips, etc. Attach Form(s) W-2	1	62,000	00
2a	Tax-exempt interest	2a	125	00
3a	Qualified dividends	3a		
4a	IRAs, pensions, and annuities	4a		
5a	Social security benefits	5a		
6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22	6		
7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6	7	62,125	00
8	Standard deduction or itemized deductions (from Schedule A)	8	24,000	00
9	Qualified business income deduction (see instructions)	9		
10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-	10	38,125	00
11	a Tax (see inst.) (check if any from: 1 <input type="checkbox"/> Form(s) 8814 2 <input type="checkbox"/> Form 4972 3 <input type="checkbox"/>)	11	4,194	00
12	b Add any amount from Schedule 2 and check here <input type="checkbox"/>	12		
13	a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here <input type="checkbox"/>	13	4,194	00
14	Subtract line 12 from line 11. If zero or less, enter -0-	14		
15	Other taxes. Attach Schedule 4	15	4,194	00
16	Total tax. Add lines 13 and 14	16	5,300	00
17	Federal income tax withheld from Forms W-2 and 1099	17		
18	Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863	18	5,300	00
19	Add lines 16 and 17. These are your total payments	19	1,106	00
20a	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you overpaid	20a	1,106	00
21	Amount of line 19 you want refunded to you. If Form 8888 is attached, check here <input type="checkbox"/>	21		
22	Routing number b Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	22		
23	Account number	23		
24	Amount of line 19 you want applied to your 2019 estimated tax	24		
25	Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions	25		
26	Estimated tax penalty (see instructions)	26		

Refund

Direct deposit? See instructions.

Amount You Owe

Form 1040

There are many online options like the one Jeff and Maria chose to use. You can find Form 1040 and any others that you may need to complete. Strong **technology skills** allow you to take advantage of these tools that lead to increased efficiency and accuracy. It is a wise investment to learn more about these tools so you can select the one that is the best fit for you.



TERM TO KNOW

Filing Status

Determined by your marital status and the presence of dependents.

2b. Dependents

If a taxpayer is providing a home for another person, then the taxpayer may be able to claim the other person as a dependent on his or her tax return. Claiming a dependent may entitle a taxpayer to preferential filing status (head of household) and other tax benefits. On the other hand, if you are claimed as a dependent by someone else, you may lose certain tax benefits (these benefits go to the person who claims you).

Although the definition of a tax dependent can get complicated, there are two basic categories of dependents: children and relatives. The most common type of dependent is a child. **Qualifying children** are considered dependents of the taxpayer. Qualifying children must pass four general tests: support, age, relationship, and abode. These are outlined in the chart below.

Support	<ul style="list-style-type: none">• The child did not provide more than half of his or her own support during the tax year.
Age	<ul style="list-style-type: none">• At the end of the tax year, the child was:<ul style="list-style-type: none">♦ Younger than 19 and younger than the taxpayer.OR♦ A full-time student, younger than 24, and younger than the taxpayer.
Relationship	<ul style="list-style-type: none">• Taxpayer's child, adopted child, stepchild, foster child, or his or her descendant.OR• Taxpayer's sibling, half-sibling, step-sibling, or descendant of any of them.
Abode	<ul style="list-style-type: none">• The child must live with the taxpayer for more than half the year, excluding temporary absences such as schooling, vacations, and illness.

Let's say that you take care of your mom, who currently lives with you. She certainly would not qualify as your child, but you might be able to claim her as a dependent on your tax return as a **qualifying relative** (and therefore also be able to choose head of household filing status). A qualifying relative is a dependent who meets all the following requirements:

- He or she is not a qualifying child of another person.
- His or her relationship to the taxpayer is that of child (as defined previously), parent, grandparent or direct ancestor, aunt, or uncle.
- The relative has less than \$4,150 (in 2018) of gross taxable income.
- The taxpayer provides more than half the dependent's support.



One important exception to the relationship requirement is that if an unrelated person lives with you for

the entire year, then she or he satisfies the relationship test.
As with all tax issues, certain guidelines apply.

- A taxpayer cannot claim a dependent if he or she is listed as a dependent on someone else's tax return.
- A dependent cannot be claimed on two different tax returns.



TERMS TO KNOW

Qualifying Children

Dependents of a taxpayer who must pass four general tests: support, age, relationship, and abode.

Qualifying Relative

A dependent who is not a qualifying child of another person, but meets other requirements to be lawfully recognized as a dependent.

3. Calculating Total Income

The first step in figuring your income tax amount is to calculate your total income, also known as your gross income.

3a. Gross Income

Gross income is the sum of all your income, including the following.

- Wages and salary from work
- Income from self-employment, partnerships, and so forth
- Interest, dividends, capital gains, and rents
- Scholarships and grants in excess of tuition and books
- Unemployment benefits and bartering
- Alimony received
- Pensions and retirement plan distributions

Some types of income are excluded from gross income and therefore they are not calculated in determining the tax base:

- Loan proceeds
- Gifts and inheritances
- Scholarships (educational assistance) used for tuition, fees, and required books and supplies
- Capital gain on sale of primary residence (up to \$250,000 for those who are single and \$500,000 for those who are married)
- Life insurance death benefits
- Fringe benefits through employment, such as health insurance premiums
- Qualifying distributions from Roth IRAs
- A portion of, or all, Social Security benefits
- Municipal bond interest

If you plan ahead, you can structure some of your financial endeavors in such a way as to produce income

that is **excluded** from gross income, such as selling your personal residence, earning a scholarship for tuition/fees/books, or having your employer pay for your tuition.



TERM TO KNOW

Exclusion

A type of income that is excluded from gross income and not calculated in determining the tax base.

3b. Determining Adjusted Gross Income

Throughout the year, you may also incur daily living expenses that you can use to reduce your gross income. These **deductions**, which are specific expenses allowed by Congress that can be used to offset gross income, will result in an **adjusted gross income (AGI)** amount that is reported on Form 1040.

There are two types of deductions: (1) FOR AGI deductions which are used to calculate AGI and (2) FROM AGI deductions which reduce AGI further to calculate taxable income.

Examples of FOR AGI deductions include:

- Interest paid on student loans
- Contributions to a Health Savings Account (contribution limit for a single individual is \$3,450 in 2018)
- Contributions to a traditional IRA (contribution limit is \$5,500) and contributions to other self-employed retirement plans
- Health insurance premiums paid by self-employed individuals

FROM AGI deductions are not used to calculate AGI but do further reduce AGI. When claiming FROM AGI deductions, taxpayers can either claim the standard deduction (available to all taxpayers) or itemize their deductions.



HINT

If Congress has not specifically allowed the deduction, then you can't claim it on your tax return. If you are ever in doubt about what is or is not allowed, check the [IRS website](#).



TERMS TO KNOW

Deduction

Specific expenses allowed by Congress that can be used to offset gross income.

Adjusted Gross Income (AGI)

Income amount reported on Form 1040 after applying allowed deductions.

3c. Taxable Income

Taxable income is the amount remaining after the standard deduction or itemized deductions. Taxable income is your tax base that will be used to determine your income tax. Your income does not equal your taxable income (tax base). As we have discussed, there are many exclusions and deductions that you can take to minimize your tax base while still enjoying your full income to achieve your goals.



WATCH

No two tax situations are the same! Check out one person's experience with filing her taxes and how technology and hiring a professional played key roles.



TERM TO KNOW

Taxable Income

The amount remaining after the standard deduction or itemized deductions. It is your tax base used to determine your income tax.



SUMMARY

The **tax return process** affects every working American. It is important you don't procrastinate to make sure your returns are accurate and precise. In this lesson, you looked at an **overview of federal income tax returns**. You studied the general **tax formula** and how it applies to the **tax return process**. After **entering your personal information** on your return, you list your **filing status**, such as married or single, and any people you care for, called **dependents**. Every tax return involves **calculating total income**, also called **gross income**. You can reduce your taxable gross income by subtracting allowable daily living expenses that you incur, as determined by Congress. The result is an **adjusted gross income** that you report on your tax return. Your **taxable income** is the amount on which the government bases your income taxes after standard or itemized deductions have been made. There are many digital tools available for calculating and filing your returns. Strong technology skill means you can choose what works best for you.

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TERMS TO KNOW

Adjusted Gross Income (AGI)

Income amount reported on Form 1040 after applying allowed deductions.

Deduction

Specific expenses allowed by Congress that can be used to offset gross income.

Exclusion

A type of income that is excluded from gross income and not calculated in determining the tax base.

Filing Status

Determined by your marital status and the presence of dependents.

Qualifying Children

Dependents of a taxpayer who must pass four general tests: support, age, relationship, and abode.

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Tax Return

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Taxable Income

The amount remaining after the standard deduction or itemized deductions. It is your tax base used to determine your income tax.