

Taxes

Basic Sections of a Federal Income Tax Return

Gross Income: In this section, report all taxable income earned during the tax year. This includes wages earned by working for an employer or as contract labor and investment income, such as dividends, interest and capital gains from stocks.

Adjustments: If certain items have been paid out during the year which are either not taxable or are taxable to someone else, those will be subtracted from gross income here.

Adjusted Gross Income (AGI): Once the gross income and adjustments are calculated, subtract the total adjustments from the total gross income. The result is the AGI or adjusted gross income.

Exemptions: Reduce income by subtracting a fixed amount per person on the return. This fixed amount is set by the IRS and usually changes each year. People who might be on the return include a spouse, if married filing jointly, children or other dependents legally under care.

Deductions: Subtract deductions. If there are a lot of deductible expenses, list them here. If there are not expenses which add up to more than the standard deduction, then list only the standard deduction here.

Taxable Income: To calculate taxable income, subtract exemptions and deductions from adjusted gross income. Taxable income is the amount to actually be taxed.

Tax Rate: Look up the tax rate using the tax rate schedules provided by the IRS in printed form or online. Multiply the taxable income by the tax rate. If using software or online programs, they will do this automatically.

Credits: Once the total tax due is calculated, subtract credits, if any fit the situation. The child care credit could be used if there are dependent children or the credit for the elderly and disabled.

Taxes Already Paid: Subtract any taxes paid through estimated quarterly taxes or those the employer has paid through federal withholding on paychecks.

Refund or Tax Payment Due: Take the taxable income and subtract from it any applicable credits and any taxes which have already been paid. The resulting amount is how much of a refund to expect or how much is still owed.

Taxes

Deductions - Standard vs. Itemizing

Scenario 1:

The standard deduction allowed in one year is \$5,400 and you have expenses you want to itemize to hopefully get a better deduction. Assume you own a home, but had no other deductible expense. You get your year-end report from your mortgage company and it shows you paid \$5,450 in interest. Which deduction (standard or itemized) is going to provide you with the better deduction on your taxable income?

Standard Deduction	\$5,400
Expenses Available for Itemized Deduction	\$5,450
Difference between Deductions	\$50

There really is not much benefit to taking all the time and effort to file the 1040 form for only \$50 more in a deduction, so it might be more convenient for you to do the short form and take the standard deduction.

Scenario 2:

Assuming the standard deduction stays the same as in scenario 1, but your itemized deductions total \$9,500, determine the difference between the deductions and which form (1040-EZ and 1040) is better for you to file.

Standard Deduction	\$5,400
Expenses available for Itemized Deduction	\$9,500
Difference between Deductions	\$4,100

There is a significant difference between the itemized and standard deductions. You will gain \$4,100 in additional deductions if you take the time to file the 1040 form. Assume you are in the 28 percent tax bracket and calculate how much you will save on the additional \$4,100 in deductions.

Tax Bracket	28 percent
Additional Savings in Itemized Deductions	\$4,100
Savings on Additional Itemized Deductions (\$4,100 x 28 percent = \$1,148)	\$1,148

Taxes

For all of the following examples, assume there is no state income tax and only work with federal taxes.

Gross Pay

Example:

A person working for \$10 per hour might work 40 hours in a one-week pay period. Calculate this person's gross pay.

Hourly rate of pay:	\$10
Hours worked in one week:	40
Weekly gross pay:	\$400 (\$10 x 40 hours = \$400)

Social Security and Medicare

If a person works for his/herself, this means he/she will pay 12.4 percent in Social Security on everything earned instead of only 6.2 percent if working for an employer. The same pattern is true for Medicare. Someone who works for his/herself is responsible for paying 2.9 percent on everything earned instead of only 1.45 percent. This additional cost of 7.65 percent of every dollar earned is something to consider when deciding whether or not to be self-employed.

Example:

Paid by an employer:

Taxable income:	\$400
Social Security (paid by employee):	\$24.80
Social Security (paid by employer):	\$24.80
(12.4 percent / 2 = 6.2 percent)	
(\$400 x 6.2 percent = \$24.80)	
Medicare (paid by employee):	\$5.80
Medicare (paid by employer):	\$5.80
(2.9 percent / 2 = 1.45 percent)	
(\$400 x 1.45 percent = \$5.80)	

Taxes

Federal Income Tax Withholding

Example:

A person working for \$10 per hour might work 40 hours in a one-week pay period. Calculate this person's weekly net pay.

Gross pay (40 x \$10):	\$400
Tax rate:	15 percent
Federal withholding:	\$60
(\$400 x 15 percent = \$60)	

Net Pay

Gross pay:	\$400
Federal withholding:	-60
Social Security (paid by employee):	-24.80
Medicare (paid by employee):	-5.80
Net pay:	\$309.40