

Unit 4: Taxes

Read Chapter 4 in the text.

Read Chapter 7 of The Financial Checkup.

Read this unit including websites. You may want to take your own notes.

Are taxes your favorite topic? They are not the favorite topic of most people. Why should we learn and care about taxes? Mainly because they can be a very large part of our expenses. An article in the Wall Street Journal (9-8-99) stated that taxpayers will pay more in taxes in one year than they will pay for food, clothing, and shelter combined. As the book stated, we want to practice tax avoidance (reducing tax liability through legal techniques) not tax evasion (illegally reducing taxes). This class is not a tax preparation class, we will only discuss the basics.

Types of Taxes

Progressive tax - demands a higher percent of income as income increases. You pay more as you make more. The United States Federal Income Tax is a progressive tax. As your income increases, your tax rate increases. However, your entire income is not taxed at that higher rate. Look at figure 4.1 on page 94 of the text. This is an important concept I want you to understand.

We are not taxed on exemptions or deductions. The next segment of our income is taxed at the lowest rate. These rates are changing and we will discuss that later. The next segment is taxed at the next higher rate and on up until we are taxed at our marginal tax rate. Please remember that our entire income is not taxed at our marginal tax bracket. Notice in the figure that Susan paid \$9,846.00 in taxes. If she had paid taxes on her entire income at her marginal tax rate of 27%, she would have paid \$15,579 in taxes.

Regressive tax - as income rises, the tax rate remains the same or decreases. Examples are the sales tax and the social security tax. Let's look at an example of this. Person A earned \$100 and person B earned \$1,000. They each purchased an item for \$20. They each paid sales tax of 5% or \$1. Person A paid 1/100 or 1% of their income. Person B paid 1/1000 or .1% of their income. As income increases, you pay a lower percent of your income to sales tax. Person B will probably buy more items and pay more sales tax than person A, but person A is still likely to pay a higher percent of their income.

There are MANY taxes that we pay: sales, property, income (federal, state, and sometimes local), capital gain, luxury, self-employment, social security, estate,

special use (road, fuel), and "sin taxes" (cigarettes, alcohol), etc. That is why we end up paying so much in taxes.

Sales Tax - some states have sales tax and some do not. In Utah it is called the Sale and Use Tax. The rates vary from county to county and even sometime city to city. The rates in Utah range from 5.75 to 7.75% with 4.75% going to the state and the remainder going to the counties and cities. The difference in the rates is because of services such as mass transient and recreational facilities. It is the largest single source of revenue for the state.

Property Tax - is a primary source of revenue for local governments. It funds services such as: fire and police, libraries, jails, schools, and road repairs. Property tax is based on the fair market value of the property. Owners can appeal the county assessor's property value if they feel it is not an accurate amount. The state of Utah does not raise revenue through property taxation. Certain individuals can apply to have their property tax reduced. They are:

1. Disabled veterans and their surviving spouses and orphans
2. Blind individuals
3. Those 65 and older who meet income requirements
4. Those under 65 if disabled or widowed, and who meet income requirements

Unit 4:

Federal Income Tax

Changes

The new tax relief act of 2001 has added many new changes to our federal income tax system. The lowest tax bracket was 15%. Now there is a 10% bracket. The other brackets will slowly decrease until the year 2006 when the highest bracket will be 35% instead of 39.6%. The child tax credit increased to \$1,000 per child instead of \$500. There are other changes, some will happen gradually such as an increase in the IRA limit and a reduction in the estate tax.

Federal Income Tax

A large portion of our tax bill goes to federal income taxes, even with the relief act. The rest of this unit will focus on federal income tax.

Once you have found out if you need to file, the next step is to determine which form you will use. You can use the 1040EZ if you are a single or joint filer with NO dependents. It is shorter than the regular 1040 form but you cannot itemize your deductions. This is the form many students use. The 1040A is also shorter but you can have dependents and some items such as certain IRA contributions. You still cannot itemize your deductions. If you itemize deductions, you will need to use the basic 1040 form.

The next step is to fill out the form. For this class you will need to complete a basic 1040 form for an assignment. The information for filling out the form is on the syllabus. **DO NOT ENTER YOUR OWN INFORMATION** for the assignment. Added instructions will follow.

Finally you will need to choose which method you will use to file. You can do one of the following:

1. *Hard copy by mail.* This is still the most common way to file.
2. *Electronic.* You can use the IRS e-file system. This is done by an authorized e-file provider. There may be a fee charged. The IRS is marketing this method and hopes to see 80% of all returns filed this way by 2007.
3. *Telephone.* You may be able to use the TeleFile system if you have a simple return. You must have an income of less than \$50,000. There are other restrictions also.

If you have questions about filling out your tax form, find some good help. There is often free help available. At USU, there is free tax help at tax time in the Merrill Library. Don't be afraid to contact the IRS. They are friendly and helpful. You can get recorded information by calling 1-800-829-4477. Look at the tax booklet for a list of recorded topics. Other questions can be answered by calling 1-800-829-1040.

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The 1040 Form

Next we will discuss the steps of filling out a tax form and the differences between adjustments, deductions, exemptions, and tax credits. This section will help you with the tax assignment.

The book talks about the steps of filling out a tax form. I have my own condensed version of the steps. They are:

1. Add up all of your income
2. Subtract anything you can (adjustments, deductions, exemptions) from the total income to get your income amount as low as possible.
3. Find out how much tax you owe (tax liability) on the lowest income amount.
4. Reduce the tax liability as much as you can by subtracting tax credits.

The 1040 form walks you through each of these steps. Basically we try to reduce our income amount and then try to reduce our tax liability. This is done with adjustments, deductions, exemptions, and tax credits.

😊 *Adjustments* - are subtracted from your income. Two of the most common ones are IRA deductions and student loan interest deductions. Alimony paid can also go here. Adjustments get one smile because they are good, we want to take advantage of any we can use, but they only save us a percent of each dollar. For example, if you are in the 15% tax bracket and you have a \$2,000 IRA deduction, you do not save the entire \$2,000 on taxes, rather you will save 15% of that or \$300. Three hundred dollars is great, and you should take advantage of that if you can, but it is not a \$ for \$ savings.

😊 *Deductions* - are also subtracted from your income. There are two ways to use deductions. You can take the standard deduction, an amount they tell you (it is different if you are single or filing jointly, etc.), or you can itemize. The IRS knows that everyone has some items they can deduct, so they have a standard amount everyone can use. However, if you have more than the standard amount, you can add up everything that you have and use the greater amount. Common things that can be itemized as deductions are mortgage interest, charitable contributions, and some medical expenses. Again, there is one smile because you only save the percent of your tax bracket on each dollar you deduct.

😊 *Exemptions* - are also subtracted from your income. There is a set amount for each qualifying person in the household. You multiply the set amount by the number of qualifying people and subtract that from your income. Again this is not a \$ for \$ savings but a percent of each dollar. Now your income is as low as it can get. Next you calculate how much tax you owe on that amount. Then we want to reduce that tax liability amount.

😊😊 *Tax Credits* - are subtracted from your tax liability. Some of the most common ones are the education credits and the child tax credit. These get two smiles because they are a \$ for \$ savings. That means for every dollar you have of tax credits, you save a dollar on your taxes! They do not get three smiles because they can only take your tax liability to zero, you can't get anything back. For example, if you owed \$500 in taxes and had \$650 in tax credits, you would owe nothing on your taxes, but you would not get the extra \$150 back.

😊😊😊 *Earned Income Tax Credit (EITC)* - is also subtracted from your tax liability. This credit can be used by individuals who are below certain income levels. It is higher if you have children. The EITC gets three smiles because it will actually take you beyond zero and give you a refund. It is also a \$ for \$ savings. For example, if you owed that same \$500 in taxes and had the \$650 in tax credits (including EITC), you would not only owe nothing, you would get the extra \$150 refunded to you! There is also a EITC advance payment option. This allows you to get some of your tax credit in each paycheck. Instead of waiting until the end of the year to get the benefit of the EITC, you can give a filled out W-5 form to your employer and have less taxes taken out of each paycheck.

Do you love to get a big refund? Most people do, but experts would tell you it is not the best way to handle your taxes. A Wall Street Journal article (March 7, 2001) stated that the average tax refund is \$1,927. Read chapter 7 of [The Financial Checkup](#) for information about refunds.

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Tax Assignment Information

Here is some added information to help with the tax assignment in case you have not filled out a 1040 form before.

- Mark married filing joint in the filing status section.
- Mark "yourself" and "spouse" in the exemptions section.
- Also enter the names of the children and add up the number of boxes on the right hand side of that section.
- Add both of their incomes for line 7.
- Put their interest earned on line 8a.
- Add them up on line 22.
- Put the IRA contribution on line 25 and take it to line 35.
- Subtract line 35 from 22 for line 36. Take that amount to line 37.
- Look at the box on the left for the standard deduction amount for married filing joint.
- Put that amount on line 39.
- Subtract that from 37 for line 40.
- Multiply the number of people in their family by \$3,100 for line 41.
- Subtract line 41 from 40 for line 42.
- Put their tax liability on line 43 (normally you would look it up in a table). Put it on line 45 also. Note: don't put anything on line 50 even if they were to qualify.
- Child tax credit goes on line 51. Put it on line 55 also.
- Subtract line 55 from 45 for line 56. Take that number down to line 62.
- Enter their federal income tax withheld on line 63. Take that amount to line 70.
- Find the difference between lines 70 and 62 for line 71.

Go back and check your math! For students who loose points on this assignment, it is usually because of simple math. One mistake can cause lost points for several lines.

Check the syllabus for information on printing a form, how to send me the assignment, and when it is due. Remember: **DON'T USE YOUR OWN INFORMATION FOR THIS ASSIGNMENT.** Use the information provided in the syllabus.

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Financial Checkup Assignment Information

NOTE: The Financial Checkup assignment is worth more points than anything else you will do this semester. You can start working on several of the worksheets. I have written some information that will help you do well on that assignment.

The Financial Checkup - Help for Students

The Financial Checkup booklet is self explanatory and can be completed without any extra explanation. However, as a student you may benefit from the following additional information. Some students feel that they are not at a point in their lives to benefit from the worksheets. Keep this in mind - you need to start somewhere. By doing the worksheets now you will have a base to go from. As your life becomes more complicated, you will already know how to complete the worksheets.

If you are married it is best to complete all the worksheets with your spouse combining all information. If this is not possible, try to keep as much as you can separate. If you have the class with your spouse, complete all the assignments together but turn in two copies, one with each name on it.

If you do not have an item on one of the worksheets, it is best to put a zero there. When the paper is graded, I will know you didn't just forget that portion. Following is some specific information on the worksheets:

Net Worth Statement: Be sure to use the fair market value (what you could sell it for) when writing down the amounts of the assets. You will most likely not have anything due on the taxes and utilities. This would only be if you were behind on either of these. Be sure to write total balance due, not the monthly payment on the liabilities.

Income and Expense Statement: Use your tracking information to complete this statement (turn in your tracking sheets with the worksheets). Be sure to put zeros on the income sections if you do not have an income at this time. If you receive money from parents to pay for your expenses, write that amount as income and write down how you spent it. If your parents pay for your credit card purchases, also write down what you spent and count what they pay as income. **DO NOT COUNT ANYTHING TWICE.** Don't count a credit card purchase and also your credit card payment that has the same purchase on it. Don't count money taken out of savings as income. For many of you, this will make your worksheet look

quite bad. That is likely to happen at this time in your life. Hopefully it will improve soon.

Financial Ratios: The first two come directly off the Net Worth and Income and Expense Statements. The last one, debt payment-to-income ratio need some calculation. Take your monthly debt payments from your Income and Expense Statement, add them all together and multiply that by 12. Enter that amount on the first line. Your gross income may not be on your Income and Expense Statement if you used your take-home pay on that statement. You can get that information from your tax return form or W-2 form. You can also look at a payment stub and multiply the gross amount by the number of pay periods you receive in one year.

Revolving Savings: Think of all the expenses you have throughout the year that are not regular (car registration, tuition, birthdays and holidays, insurance that isn't paid monthly, etc.) Put each expense on the worksheet under the month it is due with the amount due. Total all expenses and divide that by 12. That amount is how much you will need to take out of your monthly budget.

Retirement: This worksheet is one of the more complicated ones, but it is not hard. On line 1 just estimate how much you want to live on. You can ask someone who is retired how much they recommend. The example uses \$45,000. This would be a moderate income. If you do not have a Social Security Benefit Statement for line 2, you can use the example information. Line 3 is for a defined contribution pension only. Most companies do not use this type of retirement plan now. You will likely have zero on this line. Line 7 is used for the more common 401(k) plans. Follow all of the steps to reach the amount you need to save each year to reach your retirement goals. If you find that it is a very high number there may be several reasons. If you do not have a work retirement program yet, the worksheet shows that you need to save more to make up for that. Also, if you plan to retire before age 65, you will need to save a lot more. Try changing your retirement age and see how much difference that makes. Finally, this worksheet does take inflation and taxes into account, however, it is based on a moderate investment. If you invest more aggressively, you may not need to save as much each year.

Life Insurance: If you do not have any dependents, the amount on life 1 will be zero. This is only the amount you want to leave behind for your dependents. Line 8 will also be zero if you have no dependents because there will be no one to receive the benefits.

Goals: Complete at least one goal in each area (short, intermediate, long). Try to be as specific as possible with each goal.

Budget: If you do not have an income at this time, but sure to put zeros on the total lines on the income section. Use your Income and Expense Statement to

estimate what you will spend (budgeted column). Write down what you actually spend during the month (actual), and find the difference between the two columns for each item (difference). It is easier to find the difference between the sub-totals and total by just using those numbers instead of adding and subtracting all the differences for each item.

Paper: Analyze each worksheet. Explain what you learned from each worksheet and what your financial situation looks like in each of those areas. Each evaluation needs to only be one paragraph. Make sure you put a heading on each paragraph for each worksheet. Write one paragraph evaluating your overall financial situation.

The worksheets for the Financial Checkup are available online at the [Family Life Center](#) website. You can go to their website, click on "Financial Worksheets".