**Chapter 8 Notes**

**Individual Income Tax and Tax Credits**

**Preferential Tax Rates for Capital Gains and Dividends**

1. Qualified dividends: generally 15%

2. Long-term capital gains: generally 15%

3. Definition of a capital asset:

Any asset other than:

(1) Accounts receivable from the sale of goods or services,

(2) Inventory or other assets held for sale in the ordinary course of business, and

(3) Assets used in a trade or business, including supplies.

**Tax Rate Schedules** – See Appendix D (handout)

**Example**: Lexxi is a single taxpayer. This year, her taxable income is $91,000, which includes $6,000 long-term capital gain. What is Lexxi’s tax liability?

Instead, assume Lexxi’s total taxable income is $45,000, which includes $12,000 long-term capital gain. What is Lexxi’s tax liability?

**Example**: Andy is a single taxpayer. This year, his taxable income is $95,000, which includes $8,000 long-term capital gain. What is Andy’s tax liability?

Instead, assume Andy’s total taxable income is $40,000, which includes $8,000 long-term capital gain. What is Andy’s tax liability?

**Net Investment Income Tax (NIIT)**

* 3.8% tax on net investment income
* Net investment income:
  + interest, dividends, annuities, royalties, rents
  + trade or business that is passive activities ( Ch. 7)
  + net gain from disposition of assets
  + less allowable deductions
* Items not subject to NIIT: tax exempt interest, veterans’ benefits, gain excluded from sale of principal residence, distributions from qualified retirement plans, and amounts subject to self-employment tax
* NIIT is imposed on 3.8% of the lesser of:
  + Net investment income; **OR**
  + Excess of modified AGI over:
    - $250,000 for MFJ and surviving spouse
    - $125,000 for MFS
    - $200,000 for all others

**Example**: Brandon is a single taxpayer and has AGI (and modified AGI) of $162,000 and net investment income of $6,317. How much net investment income tax will Brandon owe?

Assume instead that Brandon’s AGI is $225,000. How much net investment income tax will Brandon owe?

**Employment and Self-Employment Taxes**

*Employment Taxes*

Employer pays a portion and the employee pays a portion.

1. Employer’s portion:

OASDI (Social Security): 6.2% on the first $132,900 of salary or wages in 2019

MHI (Medicare): 1.45% of salary or wages

2. Employee’s portion:

OASDI (Social Security): 6.2% on the first $132,900 of salary or wages in 2019

MHI (Medicare): 1.45% of salary or wages, and 2.35% of salary and wages over $200,000 for single and $250,000 for MFJ in 2019

**Example**: Dawn’s salary is $180,000. How much does Dawn pay in employment taxes? How much does her employer pay?

**Example**: During 2019, Mike received a total of $150,000 in employee compensation from Apple, Inc. His compensation consisted of $125,000 in wages, $5,000 performance bonus, and $20,000 forgiveness of debt (assume Mike was solvent after the debt discharge). What is his FICA tax liability on this income?

What amount of FICA taxes for the year must Apple, Inc. pay on Mike’s behalf?

What if Mike received a total of $220,000 in employee compensation? What is his FICA tax liability on this income?

What amount of FICA taxes for the year must Apple, Inc. pay on Mike’s behalf?

What happens if the taxpayer changes jobs during the year?

*Self-Employment Taxes*

1. Self-employed taxpayers are taxed on the net earnings (gross profit – expenses) from self-employment activities.

2. Net earnings from self-employment (base for self-employment tax) = Net earnings business earnings x 92.35%

OASDI portion: 12.4% on the first $132,900 of net earnings from self-employment

MHI portion: 2.9% on net earnings from self-employment (3.8% on net earnings from self-employment in excess of $200,000 for single and $250,000 for MFJ)

Taxpayers are allowed to deduct the employer portion of self-employment taxes as FOR AGI deduction.

Deduction = employer’s portion of OASDI (net earnings up to $132,900 x .062) and MHI (net earnings x .0145)

**Example**: Drew is self-employed and has net earnings of $180,000. How much does he pay in self-employment taxes? What is his self-employment tax deduction?

**Example**: Drew is employed and earns a salary of $70,000. He also operates a successful lawn care business which produced net earnings of $60,000 this year. How much does Drew pay in employment and self-employment taxes? What is Drew’s self-employment tax deduction?

**Alternative Minimum Tax (AMT)**

*What is the purpose of AMT?*

*AMT Calculation*

Taxable Income (from the tax formula)

Plus: Standard deduction (if the taxpayer claimed the standard deduction)

Equals: Tentative Alternative Minimum Taxable Income

Plus/Minus: AMT Adjustments

Equals: Alternative Minimum Taxable Income (AMTI)

Minus: AMT Exemption Amount (if any)

Equals: AMT Tax Base

Multiply by AMT tax rate

Equals: Tentative Minimum Tax (TMT)

Less: Regular Tax Liability

Equals: Alternative Minimum Tax

*Tentative Minimum Tax Calculation*

Two Brackets:

1. 26% on the first $194,800 of AMT base ($97,400 for MFS)

2. 28% on AMT base in excess of $194,800 ($97,400 for MFS)

3. LTCG and qualified dividends are taxed at their preferential rate (0, 15%, or 20%)

**Example**: Jerry is a single taxpayer with taxable income of $125,000 (includes $5,000 of qualified dividends). Assume Jerry’s AMT base is $91,050. What is his tentative minimum tax? Assuming Jerry’s regular tax liability is $21,000, does Jerry have to pay AMT? If so, how much?

Assuming Jerry’s regular tax liability is $25,000, does he owe AMT?

**Tax Credits**

*Nonrefundable Personal Credits*

Examples: Child tax credit, child and dependent care credit, education credits (American Opportunity Credit and Lifetime Learning Credit)

*Refundable Credits*

Examples: Earned Income Tax Credit

*Business Credits*

Examples: foreign tax credit, research and development credit, employment credit

*Tax Credit Application Sequence*

1. Nonrefundable personal tax credit

2. Business credits

3. Refundable personal credits

**Example**: Sean’s tax liability is $2,000 before credits. He has $1,500 in nonrefundable credits and $1,000 in refundable credits. What is Sean’s tax due (refund)?

**Taxpayer Prepayments and Penalties**

Prepayments – withholding and estimated payments

*Underpayment Penalties* – Can avoid if:

1. pre-pay 90% of current tax liability, or

2. 100% of previous year’s tax liability (110% if AGI > $150,000)

Penalty = (Federal short-term interest rate + 3%)(Amount of Underpayment)

* Does not apply if the amount is small (i.e., less than $1,000)

*Late Filing Penalty*

*Late Payment Penalty*