**Chapter One**

**The Individual Income Tax Return**

**2021**

**Icebreaker and Learning Objectives (Slides 2-4)**

* The Icebreaker gives students an opportunity to get to know each other as they consider the purpose the income tax system and how well the system meets its goals.
* The Learning Objectives provide students with a brief overview of what they will learn in this chapter.
  + LO 1.1 Explain the history and objectives of U.S. tax law.
  + LO 1.2 Describe the different entities subject to tax and reporting requirements.
  + LO 1.3 Apply the tax formula for individuals.
  + LO 1.4 Identify individuals who must file tax returns.
  + LO 1.5 Determine filing status and understand the calculation of tax according to filing status.
  + LO 1.6 Define qualifying dependents.
  + LO 1.7 Determine the tax impact of the economic impact payment and the recovery rebate credit.
  + LO 1.8 Calculate the correct standard or itemized deduction amount for taxpayers.
  + LO 1.9 Compute basic capital gains and losses.
  + LO 1.10 Access and use various Internet tax resources.
  + LO 1.11 Describe the basics of electronic filing (e-filing).

**Learning Objective 1.1 History and Objectives of the Tax System (Slides 5-7)**

The U.S. income tax was authorized by the Sixteenth Amendment to the Constitution on March 1, 1913.

* Prior to its adoption, the U.S. government had levied various income taxes for limited periods of time (e.g., to finance the Civil War).
* The finding by the U.S. Supreme Court that the income tax law enacted in 1894 was unconstitutional led to the adoption of the Sixteenth Amendment in 1913, just in time to assist in U.S. war efforts during WWI.
* Since this amendment was adopted, the constitutionality of taxing income has not been questioned again before federal courts.

Income taxes do more than provide revenue to operate government.

* Income taxes also serve as a tool of economic and social policy.
  + Tax credits and deductions reward the individual taxpayer for making particular choices.
* Some tax provisions meet both economic and social goals.
  + Example: Gain on the sale of a personal residence is excluded from taxable income; it helps a family more easily afford a new home and ensures that the United States has a mobile workforce (employees are not penalized for moving).

The Tax Cuts and Jobs Act of 2017 (TCJA) was the most sweeping tax reform bill since 1986 and includes provisions such as the following:

* Elimination of personal exemptions and increase in standard deduction
* Lowering of individual rates for taxpayers and flattening of corporate rate to 21%
* Limitation/elimination of certain itemized deductions

The poll on Slide 7 encourages students to consider which goal of the income tax system is most important. An argument could be made for each of the answers. It would depend on the priorities of the individual answering the question. The current economic needs of the country may also influence the importance of each goal.

**Learning Objective 1.2 Reporting and Taxable Entities (Slides 8-13)**

Under U.S. tax law, there are five basic tax reporting entities: individuals, corporations, partnerships, estates, and trusts.

Individuals report on Form 1040 with attached schedules:

|  |  |
| --- | --- |
| **Schedule** | **Primary Purpose** |
| 1 | Additional forms of income such as IRA distributions and Social Security benefits; deductions for adjusted gross income |
| 2 | Additional taxes such as the alternative minimum tax |
| 3 | Credits and payments other than withholding |

**Major Tax Forms and Schedules** (in addition to schedules already listed)

|  |  |
| --- | --- |
| **Form/Schedule** | **Description** |
| 1040 | Individual return |
| Schedule A | Itemized deductions |
| Schedule B | Interest and dividend income |
| Schedule C | Profit or loss from business (sole proprietorship) |
| Schedule D | Capital gains and losses |
| Schedule E | Supplemental income or loss (rent, royalty and pass-through income from Forms 1065, 1120S, and 1041) |
| Schedule F | Farm and ranch income |
| 1120 | Corporate tax return, long form |
| 1120S | S corporation tax return |
| 1065 | Partnership information return |
| Schedule K-1 | Allocation of partnership results |
| 1041 | Fiduciary (estates and trusts) tax return |

**The Corporation**

* Corporations are taxed at a flat rate of 21%.
* Corporations need to file Form 1120.
* Form 1120S is used by corporations that elect S corporation status.
  + They don’t pay regular corporate income taxes.
  + Instead, they pass through items of income or loss to shareholders.

**The Partnership**

* A partnership is a reporting entity, not a taxable entity.
* Form 1065 is used to report partnership income/loss and allocation to partners.
  + Pass-through items of income or loss to partners

The Knowledge Check on Slides 12-13 confirms that students recognize the appropriate form and schedule for an individual taxpayer who receives dividends of $2,000 and does not itemize deductions. This taxpayer would file Form 1040 and Schedule B.

**Learning Objective 1.3 The Tax Formula for Individuals (Slides 14-20)**

This tax formula follows Form 1040:

Gross Income

– Deductions for Adjusted Gross Income

= Adjusted Gross Income (AGI)

– Greater of Itemized Deductions or the Standard Deduction

– Qualified Business Income Deduction

= Taxable Income

× Tax Rate

= Gross Income Tax Liability and Additional Taxes

– Tax Credits and Prepayments

= Tax Due or Refund

*Gross income* includes all income, unless tax law provides for a specific exclusion.

*Deductions for adjusted gross income (AGI)* include the following:

* Certain trade or business expenses
* Certain reimbursed employee business expenses paid under an accountable plan
* Pre-2019 alimony payments
* Student loan interest
* Penalty on early withdrawal from savings
* Contributions to qualified retirement plans
* Certain educator expenses

*Adjusted gross income (AGI)* is the basis for limits for some deductions such as medical expenses.

*Itemized deductions* include medical expenses, certain interest expenses, certain taxes, charitable contributions, miscellaneous deductions, and certain casualty losses.

**Standard Deduction Table**

|  |  |
| --- | --- |
| **Filing Status** | **2020 Standard Deduction** |
| Single | $12,400 |
| Married, filing jointly | 24,800 |
| Married, filing separately | 12,400 |
| Head of household | 18,650 |
| Qualifying widow(er) | 24,800 |

* + Taxpayers who are 65 years of age or older or blind are entitled to an additional standard deduction for blindness. This extra amount is $1,300 for married taxpayers and surviving spouses and $1,650 for unmarried taxpayers.

A taxpayer’s *gross tax liability* is obtained from a tax table or a tax schedule.

*Tax credits and prepayments* are subtracted from gross tax liability to calculate the net tax due to the government or the refund due the taxpayer.

The Self-Study Problem on Slides 19-20 gives students the opportunity to calculate gross income, AGI, deduction amount, and taxable income for a taxpayer.

**Learning Objective 1.4 Who Must File (Slides 21-26)**

Who must file is based on filing status and gross income. Slides 21-23 include information that details who must file. Slide 21 shows the chart that applies to most people, while Slide 22 contains filing requirements for children and other dependents. Slide 23 details other situations when a person must file. Some of those situations are listed below:

* You owe any special taxes, such as Social Security and Medicare tax on tips.
* You have to pay alternative minimum tax, tax on an individual retirement account, or recapture of taxes or the first-time homebuyer credit.
* You (or your spouse if filing jointly) received health savings account, Archer MSA, or Medicare Advantage MSA distributions.
* You had net earnings of $400 or more from self-employment.
* You had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer Social Security and Medicare taxes.
* Advance payments of the premium tax credit or health coverage tax credit were made for you.
* You are required to include amounts in income under Section 965.

A taxpayer must send the tax return to the IRS Campus Processing Site by the fifteenth day of the fourth month of the year following the close of the tax year, or e-file by that date. Two exceptions are for Patriots’ Day in Maine and Massachusetts and Emancipation Day in the District of Columbia.

A six-month extension may be requested on Form 4868 by the April due date, but the taxpayer still needs to pay the tax due by April due date to avoid penalties.

*A taxpayer otherwise not required to file a return must do so to receive an income tax refund.*

The discussion on slides 25-26 asks student to consider the filing status of a single person, and to come up with different scenarios in which such a person may or may not have to file.

**Learning Objective 1.5 Filing Status and Tax Computation (Slides 27-32)**

The tax law has five different filing statuses: single, married filing jointly, married filing separately, head of household, and qualifying widow(er).

Head of household status applies if the taxpayer was an unmarried or abandoned spouse as of December 31 of the tax year and provides more than half of the cost of keeping a home that was the principal place of residence of a dependent child or other qualifying dependent relative.

Qualifying widow(er) status applies to a taxpayer after the death of a spouse with a dependent child in the home; it continues for two years after the death of the spouse.

For 2020, there are seven income tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

* The tax rates applicable to net long-term capital gains currently range from 0% to 31.8% depending on the taxpayer’s tax bracket and the kind of capital asset. This is discussed in detail in Chapter 4.
* The tax rates for qualifying dividends range from 0% to 23.8%. This is discussed in detail in Chapter 2.

The Knowledge Check on Slides 31-32 asks students to determine the filing status of a married taxpayer whose spouse left midyear and has no dependents. That taxpayer would file as married, filing separate returns.

**Learning Objective 1.6 Qualifying Dependents (Slides 33-41)**

Taxpayers are allowed two types of exemptions:

* A dependent is an individual who meets the tests discussed below for either a qualifying child or qualifying relative.
* The TCJA eliminated exemptions, but dependents are still important for reasons such as credits and head of household status.

In order for a child to be considered a dependent, the following tests must be met:

1. Relationship Test

* The child must be the taxpayer’s child, stepchild, or adopted child, or the taxpayer’s brother or sister, half-brother or half-sister, or stepsibling, or a descendant of any of these.
* The child must be younger than the person claiming him or her, unless the child is permanently disabled.

1. Domicile Test

* The child must have the same principal place of abode as the taxpayer for more than six months of the tax year.

1. Age Test

* The child must be under age 19 or a full-time student under the age of 24.
* A full-time student is defined as enrolled for at least five months in a tax year.

1. Joint Return Test

* The child must not file a joint return with his or her spouse.

1. Citizenship Test

* The dependent must be a U.S. citizen, a resident of the United States, Canada, or Mexico, or an alien child adopted and living with a U.S. citizen.

1. Self-Support Test

* The taxpayer must provide more than one-half of the child’s support. Support includes expenditures for food, lodging, clothes, medical and dental care, and education.

What if the child meets dependency requirement for more than one taxpayer?

* If one of the parties is a parent, he or she can claim the dependent.
* If both parties are a parent, then the one with whom the child resides longest can claim the dependent.
  + If residential period is not ascertainable, the parent with the highest AGI may claim the dependent.
* If no parents are involved, the person with the highest AGI may claim the dependent.

*Note:* If parents are legally separated or divorced, the parent with whom the child resides more than six months may claim the dependent. However, dependency can shift if the custodial parent signs Form 8332, and the form is attached to the noncustodial parent’s tax return.

The Discussion on slides 37-38 presents the case of a child who would qualify as a dependent for both his mother and his aunt. Students are asked to consider under what circumstances the aunt would be able to claim the child as a dependent, and why the child's mother and aunt might want the aunt to claim the child.

In order to qualify as a relative, the following tests must be met:

1. Relationship or Member of Household Test

* The dependent must be related to the taxpayer or spouse or be a member of the household.
* The list of qualifying relatives includes parents, grandparents, children, grandchildren, siblings, aunts and uncles by blood, nephews and nieces, “in-laws”, and adopted children.
* Any person who lived in the taxpayer’s home as a member of the household for the entire year meets the relationship test.

1. Gross Income Test

* A dependent must receive less than $4,200 in gross income to qualify.

1. Support Test

* A dependent must receive over half of his or her support from the claiming taxpayer or spouse.

1. Joint Return Test

* The dependent must not file a joint return unless it is only to claim a refund of taxes.

1. Citizenship Test

* The dependent must be a U.S. citizen, a resident of the United States, Canada, or Mexico, or an alien child adopted by and living with a U.S. citizen in a foreign country.

**Credits for Dependents**

* Dependent status is important for claiming tax credits for qualified dependents, even though exemption is eliminated from 2018–2025.
* Tax credits reduce tax liability dollar for dollar, while deductions lower the taxable income.
* The 2020 child tax credit is $2,000 per child under 17 with a Social Security number.
* The 2020 tax credit for “other dependents” is $500 each (qualifying child or qualifying dependent).

**Learning Objective 1.7 Economic Impact Payment and Recovery Rebate Credit (Slides 42-43)**

The economic impact payment (EIP) and recovery rebate credit (RRC) are one-time actions in response to the economic impact of the COVID-19 pandemic.

* EIP is a direct payment to certain taxpayers.
  + Starts at $1,200 ($2,400 for married filing jointly)
  + Additional $500 for each qualifying child
  + Phases out at 5% for AGI that exceeds $150,000 for married filing jointly, $75,000 for single, and $112,500 for head of household.
* RRC is a credit that accounts for situations when EIP is not representative of taxpayer's tax position.
  + 2020 refundable tax credit
  + Same amount and phase-out limits as EIP
* EIP is considered an advanced refund of the RRC
  + If equal, they offset
  + If EIP exceeds RRC, taxpayer does not pay back excess
  + If EIP is less than RRC, excess RRC can be claimed as refundable credit

**Learning Objective 1.8 The Standard Deduction (Slides 44-50)**

The standard deduction was put into the tax law to aid taxpayers with few itemized deductions.

If a taxpayer has less gross income than his or her standard deduction, he or she has no taxable income.

The following chart shows the 2020 standard deduction amounts.

|  |  |
| --- | --- |
| **Filing Status** | **2020 Standard Deduction** |
| Single | $12,400 |
| Married, filing jointly | 24,800 |
| Married, filing separately | 12,400 |
| Head of household | 18,650 |
| Qualifying widow(er) | 24,800 |

* There are additional amounts for Old Age and Blindness.
* The following taxpayers cannot use the standard deduction, but must itemize instead:
  + A married individual filing a separate return, whose spouse itemizes deductions
  + Most nonresident aliens
  + An individual filing a short-period tax return resulting from a change in the annual accounting period
* The total standard deduction for a dependent may not exceed the greater of $1,100 or the sum of $350 plus the dependent’s earned income up to the basic standard deduction amount plus any additional standard deduction for old age or blindness.

Slides 47-50 walk students through two examples of dependent children who face special limitations because of other earnings.

**Learning Objective 1.9 A Brief Overview of Capital Gains and Losses (Slides 51-58)**

When taxpayers sell assets, the resulting transaction normally creates a gain or a loss. The basic formula for calculating a gain or loss is:

Gain (or loss) realized = Amount realized – Adjusted basis

* Most realized gains/losses are also recognized for tax purposes.
* A capital asset is any property (personal or investment) held by a taxpayer, with certain exceptions as listed in the tax law.
  + Examples: Stocks, bonds, land, cars, boats, and other items held as investments or for personal use
  + Gains/losses on these assets are subject to special rates based upon income level.
* The holding period of an asset determines its treatment.
  + Long-term is held more than 12 months and taxed at capital rates.
  + Short-term is held 12 months or less and taxed at ordinary rates.
* Long-term capital gain is taxed at special rates depending upon taxpayer’s bracket.
  + The table on Slide 54 shows the tax rates, based on filing status and income; also note there are special higher rates for “high-income” taxpayers (covered in Chapter 6).
* Long-term capital losses are only allowed $3,000 per year against ordinary income.
  + Any unused balance can be carried forward to future years.

Chapter 8 of the text explores gains and losses in more detail.

The Self-Study Problem on slides 57-58 asks students to evaluate the capital gain or loss for an individual who bought stock and then sold it after holding it for several years.

**Learning Objective 1.10 Tax and the Internet (Slides 59-61)**

The IRS has a site where taxpayers can obtain forms, publications, and regulations and view various tax-related articles.

* The IRS site, [www.irs.gov](http://www.irs.gov/), allows taxpayers to communicate with the IRS via e-mail.
* The IRS also offers IRS2GO, a mobile phone app.
* The IRS has launched a YouTube video channel, a podcast, a Twitter account, and a Linkedin, Instagram, and Facebook page.
* Intuit offers tax preparation products such as ProConnect Tax, Lacerte, and Turbo Tax.
  + Taxpayers can find ProConnect help at http://proconnect.intuit.com/community/support/.

Poll 2 on slide 61 asks students which resource they would go to first for online help or information from the IRS. There is no correct answer. The IRS website may be the most comprehensive resource, because of the ability to search for and download needed forms, instructions, and publications. However, any of the other platforms might be a first stop, depending upon the type of information sought.

**Learning Objective 1.11 Electric Filing (e-filing) (Slide 62)**

Electronic filing (e-filing) is the process of transmitting federal income tax return information to the IRS Service Center using a device with Internet access. Two methods of e-filing exist:

* The first method is e-filing using a computer and tax preparation software to transmit information to the IRS.
* The second method is to employ a professional tax preparer to send the information.

More than 90% of all individual taxpayers now e-file. In the future, e-filing will likely be required for most tax returns filed.

**Case Studies (Slides 63-64)**

Case Study 1 considers the case of a 23-year-old full-time student who lives with his married brother and sister-in-law. Students are asked to refer to Publication 501 to determine whether or not the married couple can claim the student as a qualifying child, and then write a letter explaining their reasoning.

Case Study 2 examines the case of a couple who married mid-year. They want to file single, rather than married filing jointly, to realize a larger combined refund. Students should consider the legal and ethical implications, and prepare an e-mail responding to the query.

**Summary (Slides 65-66)**

The Summary slides review the 11 Learning Objects, covering what the students should have learned in this lesson.