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Tax Planning for Form 1040

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What is tax planning for Form 1040?

If you are an individual taxpayer who completes federal income tax Form 1040, you should be aware of a number of tax-planning opportunities that could lower your tax bill. Topics you should review include your selection of a filing status , the tax calculation rules, available deductions and exemptions, available tax credits, year-end tax planning techniques, and year-end investment decisions. In addition, you should become familiar with the rules surrounding tax refunds, taxes owed, options when you can't pay your tax bill immediately, and IRS audits.

What should you know about selecting a filing status?

Marital status is determined on the last day of the tax year (December 31 for most taxpayers). There are five possible filing statuses--single, head of household, married filing jointly, married filing separately, and qualifying widow(er) with dependent child. The following rules apply:

Single

You can select single as your filing status if you were unmarried as of the last day of the tax year and were not eligible to claim another filing status.

Head of household

You may be able to claim head of household status if you were unmarried or considered unmarried on the last day of the year; you paid more than half the cost of keeping up a home for the year; and, a qualifying person lived with you in the home for more than half the year.

Married filing jointly

You and your spouse (or former spouse) can choose to file a joint return if you were married to each other through the last day of the tax year, even if you were living apart.

Married filing separately

You can select married filing separately as your filing status if you are married or if you are no longer married but were married to your former spouse up to and including the last day of the tax year (December 31 for most taxpayers).

Concept of the "marriage penalty"

The term "marriage penalty" typically refers to the inequitable result that can sometimes occur when a couple who files married filing jointly (MFJ) winds up with a tax liability that is greater than it would have been if they were unmarried and filing as single individuals. This might occur, for example, when the tax code provides tax brackets that are wider but not twice as wide as those for single filers, or in situations where a deduction or credit is phased out at an income level that is less than twice that of a single individual. Whether spouses experience the marriage penalty depends on many factors including the distribution of earnings between them (some spouses may actually experience a "marriage bonus"). Spouses who earn relatively equal amounts are more apt to experience the penalty than spouses who earn disproportionate amounts.

The Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Working Families Tax Relief Act of 2004, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and the American Taxpayer Relief Act of 2012 all reduced, but did not completely eliminate, the marriage penalty by (1) increasing the MFJ standard deduction to twice the single standard deduction, and (2) widening the MFJ 15 percent tax bracket to twice as wide as the single 15 percent tax bracket.

What should you know about tax calculation?

If you file Form 1040, you must compute your adjusted gross income (AGI) and your taxable income before you can calculate your tax. Essentially, your AGI is your total income minus certain adjustments. Your taxable income is your AGI minus your itemized deductions (or standard deduction) and your exemptions. After finding your taxable income, you need to determine your income tax liability from the tax tables or tax rate schedules. This tax amount is then reduced by certain credits to which you may be entitled and increased by any other taxes you may owe. In terms of tax calculation and tax planning, the following taxes deserve particular note.

Alternative minimum tax (AMT)

The purpose of the alternative minimum tax (AMT) is to ensure that taxpayers with substantial income will not escape federal income taxation entirely by employing certain exclusions, deductions, and credits. The federal income tax law gives special treatment to some kinds of income and allows special deductions and credits for some expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax--the AMT. By understanding the AMT, you may discover planning opportunities that will allow you to keep your AMT exposure to an absolute minimum.

Capital gains tax

Currently, the highest marginal tax rate applicable to ordinary income is 39.6 percent, whereas the top long-term capital gains rate is generally 20 percent (which is substantially lower). Therefore, if you can generate net capital gains instead of ordinary income, there's the potential to save considerably on your taxes. You generate capital gains by selling capital assets (such as stocks). Certain dividends are also taxed at capital gains tax rates.

Tip: *Long-term capital gains are generally taxed at a maximum rate of 0 percent for taxpayers in the 10 or 15 percent marginal tax brackets; 15 percent for taxpayers in the 25 percent, 28 percent, 33 percent, or 35 percent marginal tax brackets; and, (for tax years after 2012) 20 percent for those in the 39.6 percent marginal tax bracket.*

Tip: *Qualified dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are also taxed at the same maximum rates that apply to long-term capital gains.*

Self-employment tax

Self-employed taxpayers are subject to a special tax- the self-employment tax . You must file Schedule SE if either of the following applies to you (or to your spouse if you file a joint return):

- You were self-employed and your net earnings from self-employment were $400 or more
- You had church employee income of $108.28 or more

What should you know about deductions and exemptions?

The amount of federal taxable income is figured by taking your gross income and subtracting certain allowable adjustments, deductions, and exemptions . A deduction may be defined as an expense that can be used to offset income. Taxpayers may generally subtract the greater of either their statutory standard deduction or the total of their itemized deductions. An exemption, by comparison, is a special type of deduction granted to individuals to relieve them from taxation on a certain portion of their income. In general, taxpayers are entitled to an exemption for themselves and for each of their dependents.

Knowledge of your available deductions and exemptions is an important part of your tax planning for Form 1040. If your adjusted gross income level lies above a certain specified amount, the tax benefits of personal and dependent exemptions may be phased out in tax years after 2012. In addition, certain deductions are only available to you if your expenses exceed a particular percentage of your adjusted gross income, and (in tax years after 2012) itemized deductions may be limited for higher-income individuals.

What should you know about tax credits?

You may be able to reduce your income tax liability by taking advantage of certain credits for which you may qualify. There are a number of credits available, including the following:

- Child and dependent care tax credit
- Tax credit for the elderly and disabled
- General business tax credit

- Foreign tax credit
- Adoption tax credit
- Credit for qualified retirement savings contributions
- Earned income credit
- Credit for qualified rehabilitation expenditures
- Child tax credit
- American Opportunity (Hope) tax credit
- Lifetime Learning credit

By becoming familiar with the various tax credits available (and the qualification rules), it may be possible for you to lower your tax liability.

What should you know about year-end tax planning and year-end investment decisions?

Year-end tax planning and investment decisions may often result in substantial tax savings. Tax planning primarily concerns the timing and the method by which your income is reported and your deductions and credits are claimed. The basic strategy for year-end planning is to time your income so that it will be taxed at a lower rate and to time your deductible expenses so that they may be claimed in years when you are in a higher tax bracket. Specific techniques may be utilized, including reviewing a year-end checklist of tax-saving strategies, performing a marginal tax rate analysis, shifting income, and postponing income and accelerating deductions (or vice versa). In a nutshell, you should try to:

- Recognize income when your tax bracket is low
- Pay deductible expenses when your tax bracket is high
- Postpone incurrence of income tax liability whenever possible

By using these methods, it may be possible for you to lower your overall taxes.

In terms of investment planning, investing in capital assets may help you to better control the timing of the recognition of some of your income. You usually have the flexibility to control when you recognize the gain or loss with respect to capital assets, because in most cases, you determine when to sell each asset. In some cases, however, shifting capital gain income to other taxpayers through gifting appreciated property may be appropriate for you. You should become familiar with the rules for year-end investment decision making.

What should you know about IRS issues, including refunds, taxes owed, options when you can't pay your tax bill, and audits?

After you have figured your total tax and your total payments, you must determine if you are due a tax refund or if you owe additional tax to the Internal Revenue Service.

Refund

If you are owed a refund , you must inform the IRS of whether you want all of the refund sent back to you or if you want to apply all or part of it to your estimated tax for the following year. It is possible that your refund may be rerouted by the IRS to another agency if you sign a joint return and you (or your spouse) owe certain debts. For all of these reasons, it is important to do some planning regarding your tax refunds.

Tax owed

If it turns out that you owe additional money to the IRS, you should pay it with your tax return. If not, you will have to pay interest on any tax that is unpaid, and you may be subject to penalties. You should be aware of how to remit payment for taxes owed, how to file for an extension (although this will not relieve you of your obligation to pay your taxes on time), and what to do if you can't pay your tax bill on time . Installment agreements are possible, as is an offer in compromise.

IMPORTANT DISCLOSURES

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To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

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