## Understanding Your Tax Basics

No matter what the season or your unique circumstances, when it comes to your taxes, planning usually pays off in a lower tax bill. The following is provided so that you may have a basic understanding of taxes before you discuss filing options and strategies.

- Filing Status - Except for a surviving spouse, or married individuals who have lived apart for the entire year, your filing status depends on your marital status at the end of the tax year. Generally, if you are married at the end of the tax year, you have three possible filing status options: Married Filing Jointly, Married Filing Separate, or if you qualify, Head of Household. If you were unmarried at the end of the year, you would file as Single status, unless you qualify for the more beneficial Head of Household status.

  Head of Household is the most complicated filing status to qualify for and is frequently overlooked as well as incorrectly claimed. Generally, the taxpayer must be unmarried AND:

  • Pay more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half the year of a qualifying child, or an individual (relative) for whom the taxpayer may claim a dependency exemption, or

  • Pay more than half the cost of maintaining a separate household that was the main home for a dependent parent for the entire year.

  A married taxpayer may be considered unmarried for the purpose of qualifying for the Head of Household status if the spouses were separated for at least the last six months of the year, provided the taxpayer maintained a home for a dependent child for over half the year.

  Surviving Spouse (also referred to as Qualifying Widow or Widower) is a rarely used status for a taxpayer whose spouse died in one of the prior two years and who has a dependent child at home. The joint tax rates are used, but no exemption is claimed for the deceased spouse. In the year the spouse passed away, the surviving spouse would file jointly with the deceased spouse if not remarried by the end of the year.

- **Adjusted Gross Income (AGI)** - AGI is the acronym for Adjusted Gross Income. AGI is generally the sum of a taxpayer's income less specific subtractions called adjustments (but before the standard or itemized deductions and exemptions). Many tax benefits and allowances, such as credits, certain adjustments and some deductions are limited by a taxpayer's AGI.

- **Taxable Income** - Taxable income is your AGI less deductions (either standard or itemized) and your exemptions. Your taxable income is what your regular tax is based upon using either the IRS tax tables or the rate schedule.

- **Marginal Tax Rate** - Not all of your income is taxed at the same rate. The amount equal to the sum of your deductions and exemptions is not taxed at all. The next increment is taxed at 10%, then 15%, etc., until you reach the maximum tax rate. When you hear people discussing tax bracket, they are referring to the marginal tax rate. Knowing your marginal rate is important, because any increase or decrease in your taxable income will affect your tax at the marginal rate. For example, suppose your marginal rate is 25% and you are able to reduce your income $1,000 by contributing to a deductible retirement plan. You would save $250 in Federal tax ($1,000 x 25%). Your marginal tax bracket depends upon your filing status and taxable income. Find your marginal tax rate using the table below.

  When using this table, keep in mind that the marginal rates are step functions and that the taxable incomes shown in the filing status column are the top value for that marginal rate range.

| 2014 MARGINAL TAX RATES | | | | |
|---|---|---|---|---|
| TAXABLE INCOME BY FILING STATUS | | | | |
| **Marginal Tax Rate** | **Single** | **Head of Household** | **Joint*** | **Married Filing Separately** |
| 10.0% | 9,075 | 12,950 | 18,150 | 9,075 |
| 15.0% | 36,900 | 49,400 | 73,800 | 36,900 |
| 25.0% | 89,350 | 127,550 | 148,850 | 74,425 |
| 28.0% | 186,350 | 206,600 | 226,850 | 113,425 |
| 33.0% | 405,100 | 405,100 | 405,100 | 202,550 |
| 35.0% | 406,750 | 432,200 | 457,600 | 228,800 |

| | | | | |
|---|---|---|---|---|
| 39.6% | Over 406,750 | Over 432,200 | Over 457,600 | Over 228,800 |

- * Also used by taxpayers filing as Surviving Spouse

- **Taxpayer & Dependent Exemptions** - You are allowed to claim a personal exemption for yourself, your spouse (if filing jointly) and each individual who qualifies as your dependent. The amount you are allowed to deduct is adjusted for inflation annually; the amount for 2014 is 3,950 (up from $3,900 in 2013).

  Dependents - To qualify as your dependent, an individual must be your qualified child or pass all five dependency qualifications: (1) Member of the Household or Relationship Test, (2) Gross Income Test, (3) Joint Return Test, (4) Citizenship or Residency Test, and (5) Support Test. The gross income test limits the amount of income a dependent can make if he or she is over 18 and does not qualify for an exception for certain full-time students. The support test generally requires that you pay over half of the dependent's support, although there are special rules for divorced parents and situations where several individuals together provide over half of the support.

  Qualified Child - A qualified child is one that meets the following tests:

  (1) Has the same principal place of abode as you for more than half of the tax year except for temporary absences.

  (2) Is your son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual.

  (3) Is younger than you.

  (4) Did not provide over half of his or her own support for the tax year.

  (5) Is under age 19 or under age 24 in the case of a full-time student, or is permanently and totally disabled (any age).

  (6) Was unmarried (or if married, either did not file a joint return or filed jointly only as a claim for refund).

- **Deductions** - Taxpayers can choose between itemizing their deductions or using the standard deduction. The standard deductions, which are inflation adjusted annually, are illustrated below for 2014.

| Filing Status | Standard Deduction |
|---|---|
| Single | $6,200 |
| Head of Household | $9,100 |
| Married Filing Jointly | $12,400 |
| Married Filing Separately | $6,200 |

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The standard deduction is increased by multiples of $1,550 for unmarried taxpayers who are over age 64 and/or blind. For married taxpayers, the additional amount is $1,200. Those with large deductible expenses can itemize their deductions in lieu of claiming the standard deduction.

Itemized deductions include:

(1) Medical expenses (limited to those that exceed 10% of your AGI for the year). Note: the reduction rate is 7½% for seniors age 65 and older through 2016;

(2) Taxes consisting primarily of real property taxes, state income (or sales*) tax and personal property taxes;

(3) Interest on qualified home debt and investments; the latter is limited to net investment income (i.e. the interest cannot exceed your investment income after deducting investment expenses);

(4) Charitable contributions are generally limited to 50% of your AGI, but in certain circumstances the limit can be as little as 20% or 30% of AGI,

(5) Miscellaneous employee business expenses and investment expenses, but only to the extent that they exceed 2% of your AGI;

(6) Casualty losses in excess of 10% of $100 per occurrence plus your AGI; and

(7) Gambling losses to the extent of gambling income, and certain other rarely encountered deductions.

*The option to deduct state and local sales tax instead of state and local income tax does not apply for 2014 and subsequent years, but there is a chance Congress may reinstate the provision retroactively. Please check with this office for updates.

- **Alternative Minimum Tax (AMT)** - The Alternative Minimum Tax is another way of being taxed that taxpayers frequently overlook. The Alternative Minimum Tax (AMT) is a tax that was originally intended to ensure that wealthier taxpayers with large write-offs and tax-sheltered investments paid at least a minimum tax. However, unlike the regular tax computation, for many years the AMT was not adjusted for inflation, and years of inflation drove most taxpayers' income up to the point where more and more taxpayers were being affected by the AMT. Congress finally changed the law to allow annual inflation-adjustment of the amount of income exempt from the AMT, and raised the amount of AMT taxable income at which the higher of two AMT tax rates applies. These changes have helped limit the number of additional taxpayers subject to the AMT. A full overhaul of the AMT law is yet to come from Congress. Meanwhile, your tax must be computed by the regular method and by the alternative method. The tax that is higher must be paid. The following are some of the more frequently encountered factors and differences that contribute to making the AMT greater than the regular tax.

  - Personal and dependent exemptions - are not allowed for the AMT. Therefore, separated or divorced parents should be careful not to claim the exemption if they are subject to the AMT and instead allow the other parent to claim the exemption. This strategy can also be applied to taxpayers who are claiming an exemption under a multiple support agreement.

  - The standard deduction – is not allowed for the AMT and a person subject to the AMT cannot itemize for AMT purposes unless they also itemize for regular tax purposes. Therefore, it is important to make every effort to itemize if subject to the AMT.

  - Itemized deductions:
  *Medical deductions* – only allowed in excess of 10% of AGI, now the same as for regular tax (except the reduction rate is 7½% for taxpayers age 65 or older). This difference for seniors will end when the AGI threshold percentage increases for them to 10% in 2017.
  *Taxes* – are not allowed at all for the AMT.
  *Interest* – Home equity debt interest and interest on debt for non-conventional homes such as motor homes and boats are not allowed as AMT deductions.
  *Miscellaneous deductions* subject to the 2% of AGI reduction are not allowed against the AMT.

  - Nontaxable interest from Private Activity Bonds – is tax-free for regular tax purposes but some are taxable for the AMT.

- Statutory Stock Options (Incentive Stock Options) when exercised produce no income for regular tax purposes. However, the bargain element (difference between grant price and exercise price) is income for AMT purposes in the year the option is exercised.

- Depletion Allowance – in excess of a taxpayer's basis in the property is not allowed for AMT purposes.

The AMT exemptions are phased out for higher-income taxpayers. The amounts shown are for 2014.

| AMT EXEMPTION PHASE OUT | | |
|---|---|---|
| **Filing Status** | **Exemption Amount** | **Income Where Exemption Is Totally Phased Out** |
| Married Filing Jointly | $82,100 | $484,900 |
| Married Filing Separate | $41,050 | $242,450 |
| Unmarried | $52,800 | $328,500 |

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| AMT TAX RATES | |
|---|---|
| **AMT Taxable Income** | **Tax Rate** |
| 0 – $182,500 (1) | 26% |
| Over $182,500 (1) | 28% |

- (1) $91,250 for married taxpayers filing separately

Your tax will be the higher of the tax computed the regular way or the Alternative Minimum Tax. Anticipating when the AMT will affect you is difficult, because it is usually the result of a combination of circumstances. In addition to those items listed above, watch out for transactions involving limited partnerships, depreciation and business tax credits only allowed against the regular tax. All of these can strongly impact your bottom line tax and raise a question of possible AMT. Tax Tip: If you were subject to the AMT in the prior year, itemized your deductions on your federal return for the prior year, and had a state tax refund for that year, part or all of your state income tax refund from that year may not be includable in the regular tax computation. To the extent you received no tax benefit from the state tax deduction because of the AMT, that portion of the refund is not includable in the subsequent year's income.

- **Tax Credits** - Once your tax is computed, tax credits can reduce the tax further. Credits are divided into two categories: those that are nonrefundable and can only offset the tax, and those that are refundable. In addition, some credits are not deductible against the AMT, and some credits, when not fully used in a specific tax year, can carry over to the succeeding years. Although most credits are a result of some action taken by the taxpayer, there are two commonly encountered credits that are based simply on the number of your dependents or your income.

  **Child Tax Credit** - The child tax credit is $1,000 per child. If the credit is not entirely used to offset tax, the excess portion of the credit, up to the amount that the taxpayer's earned income exceeds a threshold ($3,000 2011 through 2017) is refundable. Taxpayers with three or more qualifying dependent children may use an alternate method for figuring the refundable portion of their credit. The credit is allowed against both the regular tax and the AMT for each dependent under age 17. The credit begins to phase out at incomes (AGI) of $110,000 for married joint filers, $75,000 for single taxpayers and $55,000 for married individuals filing separate returns. The credit is reduced by $50 for each $1,000 (or fraction of $1,000) of modified AGI over the thresholds.

  **Earned Income Credit** -This is a refundable credit for low-income taxpayers with income from working, either as an employee or a self-employed individual. The credit is based on earned income, the taxpayer's AGI and the number of qualifying children. A taxpayer who has investment income such as interest and dividends in excess of $3,350 (up from $3,300 in 2013) is ineligible for this credit. The credit was established as an incentive for individuals to obtain employment. It increases with the amount of earned income until the maximum credit is achieved and then begins to phase out at higher incomes. The table below illustrates the phase-out ranges for the various combinations of filing status and earned income and the maximum credit available.

| 2014 EIC PHASE-OUT RANGE | | | |
|---|---|---|---|
| Number of | Joint Return | Others | Maximum Credit |

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| Children | | | |
|---|---|---|---|
| None | $13,540 - $20,020 | $8,110 - $14,590 | $496 |
| 1 | $23,260 - $43,941 | $17,830 - $38,511 | $3,305 |
| 2 | $23,260 - $49,186 | $17,830 - $43,756 | $5,460 |
| 3 | $23,260 - $52,427 | $17,830 - $46,997 | $6,143 |

- **Residential Energy-Efficient Property Credit** – This credit is generally for energy-producing systems that harness solar, wind or geothermal energy including solar electric, solar water heating, fuel cell, small wind energy and geothermal heat pump systems. These items qualify for a 30% credit with no annual credit limit. Unused residential energy-efficient property credit is generally carried over through 2016.

- **Withholding and Estimated Taxes** - Our "pay-as-you-go" tax system requires that you make payments of your tax liability evenly throughout the year. If you don't, it's possible you could owe an underpayment penalty. Some taxpayers meet the "pay-as-you-go" requirements by making quarterly estimated payments. However, when your income is primarily from wages, you usually meet the requirements through wage withholding and rely on your employer's payroll department to take out the right amount of tax, based on the withholding allowances shown on the Form W-4 you filed with your employer. To avoid potential underpayment penalties, you are required to deposit by payroll withholding or estimated tax payments an amount equal to the lesser of:

  **(1)** 90% of the current year's tax liability; or

  **(2)** 100% of the prior year's tax liability or, if your AGI exceeds $150,000 ($75,000 for taxpayers filing Married Separate), 110% of the prior year's tax liability.

If you had a significant change in income during the year, we can assist you in projecting your tax liability to maximize the tax benefit and delay paying as much tax as possible before the filing due date.

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