

## 4. Taxes: Paying All You Owe and Not a Penny More

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### Introduction

The present tax system in the United States was established in 1913 with the passage of the Sixteenth Amendment to the Constitution. This amendment gave Congress the power to impose an income tax. When this tax was first established, only about one percent of the population had to pay income taxes. Since that time, tax laws have changed immensely. Now, paying taxes has become one of the most complex procedures citizens must go through to fulfill their civic responsibilities.

Whether we like it or not, taxes are a fact of life. Taxes are also a critical part of any financial plan. We include a discussion of taxes early in this course because taxes have an impact on nearly every part of financial life: investing, saving, managing cash, dealing with debt, owning a home, planning for retirement, securing insurance, and planning your estate. Since taxes are such a crucial financial element, you need to understand and plan for them so you can achieve your personal and family goals.

### Objectives

When you have completed this chapter, you should be able to do the following:

- A. Understand how tax planning can help you attain your personal goals and the principles of tax planning.
- B. Understand the Federal tax process.
- C. Understand the major tax features of the U.S. tax system and tax strategies to help you lower your taxes (legally and honestly).
- D. Understand and create your Tax Plan.

### Understand How Tax Planning Can Help You Attain Your Personal Goals and the Principles of Tax Planning

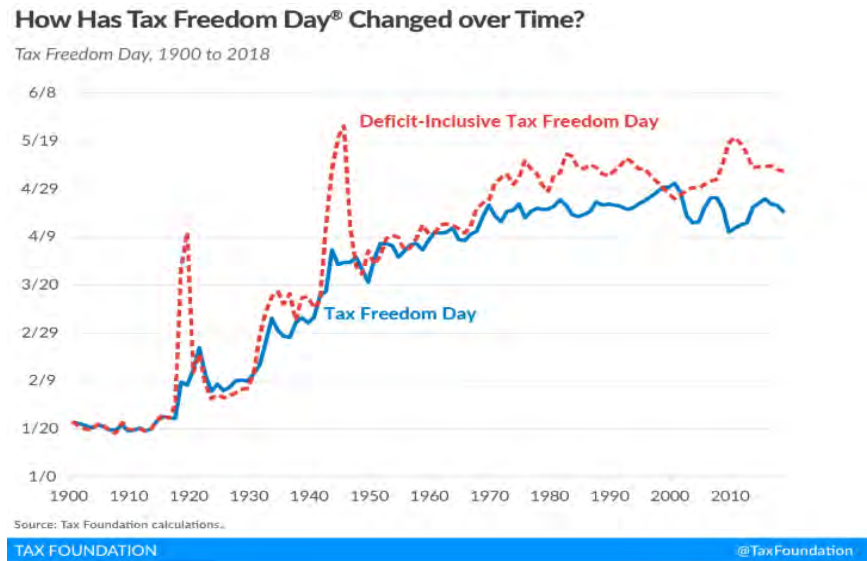
Tax planning is important because taxes are the largest single annual expense for most families. The average American spends more on taxes than on food, clothing, and medical care combined; he or she must work for more than three months just to earn enough to pay taxes. In 2011, Americans needed to work 104 days to cover the costs of their federal, state, and local taxes. The day on which taxes were covered, called Tax Freedom Day, fell on April 19 in 2018, 110 days into the year (See Figure 1).

The statistics in Figure 1 illustrate why tax planning and tax strategies should be critical parts of your financial life. The less you owe Uncle Sam, the more you can save for your personal and

financial goals.

**Figure 1. Tax Freedom Day, 1900-2018<sup>1</sup>**

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Regarding taxes and the other laws of the land, the Lord has said, “Let no man break the laws of the land, for he that keepeth the laws of God hath no need to break the laws of the land. Wherefore be subject to the powers that be, until he reigns whose right it is to reign and subdues all enemies under his feet.”<sup>2</sup>

Some citizens have tried to minimize their obligation to pay income taxes. We all should obey the laws of the land, including the laws that require us to pay taxes. However, we should learn to be wise stewards so that we pay all the taxes we legally owe—and not a penny more.

### Principles of Tax Planning

There are five key principles of effective tax management:

- 1. Know yourself, your vision, goals, and plans.** This is critical. Who are you? What are you trying to accomplish during your life for yourself and your family? What do you want to become? What is the vision of what you see for yourself and your family? What are the values you will follow as you strive to accomplish these things?
- 2. Seek, receive and act on the Spirit’s guidance.** This includes seeking diligently through study and prayer, living worthy of the Spirit’s guidance, and then acting on it once it is received.
- 3. Understand the key areas of the tax system so you can make wise decisions regarding your finances.** It is important that you understand how taxes are calculated so

you can use this knowledge to help you legally reduce your tax bill. After all, it is likely one of your larger bills each year.

**4. Keep good records for tax and other purposes.** It is important that you keep good records, including records of spending, donations, investments, etc. so you can take your earned deductions. Taxes impact so many areas of our lives. As such, it is important that we keep good records so that we pay every dollar we owe, and not a penny more.

**5. Get good help if needed to make better decisions.** Often, we do not have enough information to make the best decisions for ourselves. As such, don't be afraid to pay to have help of certified tax experts to help you understand and reduce your tax bill.

**6. Finally, pay everything you owe for taxes, and not a penny more.** It is a blessing to live in the countries we all live in. As such, we are responsible to pay our taxes, consistent with our leader's counsel.

### **Finding Balance**

Once you have your problem, the next step is to determine the principles. These might include:

<u>Principles</u>	<u>Doctrines</u>
Know yourself, your vision, goals, and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand the key areas of the tax system	Accountability
Keep good records for tax and other purposes	Stewardship
Get good help if needed to make better decisions	Stewardship
Pay everything you owe for taxes	Integrity

### **From Obedience to Consecration**

When we are planning for taxes, we are not just doing tax planning. From a higher perspective or with greater vision,

We are children of Heavenly Parents (identity), striving to live worthy of the Spirit (obedience), who are learning important information about the tax system (accountability), wisely keeping records of our income and expenses (stewardship), and getting good help when needed (stewardship). We act with integrity to minimize our tax payments to the government (honesty), so that we can have sufficient assets to accomplish our personal missions and to accomplish our individual and family vision and goals.

### **Understand the Federal Tax Process**

Preparing your income tax is a seven-step process:

1. Calculate your gross income from all sources minus IRS-allowed losses, exclusions, and deferrals.
2. Subtract adjustments to gross income to get your adjusted gross income (AGI).
3. Subtract the greater of your standard deduction or your itemized deductions.
4. Refer to the IRS tax table and calculate your tentative tax.
5. Subtract your credits; the result is your total tax owed.
6. Subtract any taxes already paid. This leaves the amount of your balance due or amount of your refund.

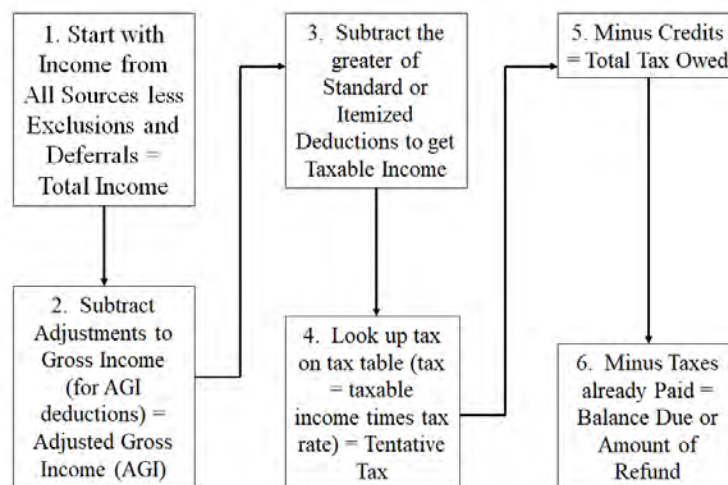
To help you with the federal tax process, we have created a spreadsheet titled [Federal Tax Worksheet](#) (LT39). Set the year for 2019 and it will help you understand the process and calculate your taxes.

### **Step 1: Calculate Your Total Income**

Your gross income comprises income from all sources unless it is allowed to be specifically excluded or deferred by the IRS. It includes active income from wages or a business; passive income from activities in which the taxpayer does not actively participate; and portfolio income from interest, dividends, and capital gains from securities. Total income also includes alimony, business income, taxable IRA distributions, tax refunds from the previous year (but only if the excess was deducted in the previous year), royalties, farm income, unemployment compensations, taxable Social Security benefits, and any other income.

**Table 1. The Tax Process**

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Occasionally the IRS allows certain sources of income to be excluded from your total income. These waived amounts are called exclusions. They include certain employer-provided fringe

benefits, *contributions to qualified retirement accounts (401k, 403b, 457, SEP plans, etc.)* that are not Roth retirement plans, life insurance proceeds that were received because of a death, scholarships or grants not in excess of college expenses, interest on U.S. Series I or EE savings bonds (when the principal and interest from these bonds have been used for qualified educational expenses), municipal bond interest, inheritances (up to a specific amount), child support payments, and some welfare benefits.

The IRS also allows certain sources of income to be deferred and recognized at a later date. These amounts are called deferrals. Deferrals include contributions, earnings, and interest on qualified retirement accounts. Taxes on these accounts are deferred until the individual retires and withdraws funds from these accounts.

### **Step 2: Subtract Adjustments to Get Your Adjusted Gross Income (AGI)**

Adjustments are deductions from your total income allowed by the IRS. The resulting number is your adjusted gross income. Adjustments include items that are paid for on a before-tax basis and items that reduce income for specific payments or taxes. Items paid for on a pre-tax basis include contributions to flexible spending plans or health savings accounts, where money for medical expenses is paid before tax. Contributions to individual retirement accounts (IRAs) that are not in Roth accounts are also adjustments. Reductions in income for specific payments include interest payments on student loans, tuition and fees deductions, and deductions of one-half self-employment tax. Note that as your adjusted gross income increases beyond a specific amount, certain adjustments to your income are phased out or eliminated, such as the ability to contribute to certain kinds of individual retirement accounts. Total income minus adjustments gives you your Adjusted Gross Income (AGI).

### **Step 3: Subtract Itemized or Standard Deductions**

Once you know your AGI, the next step is to determine your itemized deductions. Itemized deductions are IRS-allowed reductions in adjusted gross income that are used to calculate taxable income. There are two different ways to determine deductions; one way you must calculate yourself, and the other way is calculated for you. It is important for you to understand what can and cannot be deducted because every deduction results in less tax money you must pay and more money you can keep and use to achieve your personal goals.

**Table 2      Standard Deductions**

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<b>Year</b>	<b>Standard Deduction (MFJ)</b>
2015	\$12,600
2016	\$12,600
2017	\$12,700
2018	\$24,000
2019	\$24,400

The first method of calculating deductions is to let the government calculate them for you. Each

year, the government determines a “standard deduction,” which is an estimate of what the average family would be able to deduct by itemizing. Unlike itemized deductions, which are limited for higher levels of AGI, the standard deduction remains the same for all income levels. The standard deduction amount does vary depending on your filing status: the amount will be different depending on whether you are single, married filing jointly, head of household, or married filing separately. The following has been the standard deduction for married filing jointly (MFJ) for the last few years (see Table 2).

The second method for determining deductions is for the taxpayer to itemize all the deductions he or she can legally take. The government allows taxpayers to remove certain expenses it deems important from a taxpayer’s income. It is the taxpayer’s responsibility to determine and document those deductions. Some of the most common deductions include medical and dental expenses, tax expenses, state and local taxes (SALT), interest on home mortgages, charitable contributions, and investment-related expenses.

The government allows deductions for medical and dental expenses that exceed 10 percent of your AGI, casualty and theft losses that exceed 10 percent of AGI. For example, if your AGI is \$50,000, you can only deduct medical expenses that are more than \$5,000 ( $50,000 * .10$ ). The definition of acceptable medical and dental expenses can be found in IRS Publication 17.

Certain expenses are also deductible against your income earned. These expenses include investment losses up to \$3,000 per year, real estate taxes, and county or city income taxes. Some states impose a personal property tax (generally a tax on vehicles), which is also deductible. The government also allows you to deduct either state and local taxes or state and local general sales taxes, property taxes on principle residence, etc. up to \$10,000 per year.

**Table 3. Mileage Deductions**

Charitable Mileage deductions:	2017	.14 per mile
	2018	.14 per mile
	2019	.14 per mile
Business Mileage Deductions :	2017	.535 per mile
	2018	.545 per mile
	2019	.580 per mile
Moving/Medical Mileage Deductions:	2017	.170 per mile
	2018	.180 per mile
	2019	.200 per mile

You may also deduct contributions to charitable organizations. The requirement for this deduction is that the charitable organization must be qualified (registered as a 501(c)(3) nonprofit organization). Regardless of the size of the donation, you should get a receipt for your donation from the charity.

Further deductions can be taken for certain expenses relating to investing. The government wants to encourage investment, so interest paid on investments is deductible, although the deduction is

limited to the amount of investment income you earn. You can also deduct investment costs; after offsetting investment income, you can deduct up to \$3,000 in investment losses per year. Losses in excess of \$3,000 can be carried forward to deduct in future years.

Certain mileage deductions may also be made, depending on the usage of your personal vehicle (see Table 3). These uses may be related to charity, business, moving, or medical expenses.

If your income rises above a certain level, you begin losing a percentage of your deductions. The higher your income gets, the more your allowable itemized deductions are reduced. While these calculations are complicated, be aware that these adjustments may be applicable.

The challenge to the taxpayer is to determine whether his or her calculated deductions are greater than the government's standard deduction. It may be to your advantage to itemize your deductions. If the government's standard deduction is greater than your itemized deduction, then it is to your advantage to take the standard deduction. Once you understand the tax system, you can utilize the deductions that minimize your tax payments and maximize the amount that is left over for your personal goals. A good tool to help you determine whether to use itemized or the standard deduction is the [Federal Tax Worksheet](#) (LT38).

#### **Step 4: Refer to the Tax Table and Calculate Your Tentative Tax**

Once you have determined your taxable income, determine your filing status. Your filing status is based on your marital and family situation. Filing status is a factor in determining your standard deduction and your correct amount of tax. Your marital status on the last day of the year determines your status for the entire year. The five filing status options are:

- 1. Single:** Generally, if you are unmarried, divorced, or legally separated, your filing status is single.
- 2. Married filing jointly:** If you are married, you and your spouse may file a joint return.
- 3. Married filing separately:** Married taxpayers may elect to file separate returns.
- 4. Head of household:** If you are unmarried and paid more than half the cost of maintaining a home for you and a qualifying person, you may file as head of household.
- 5. Qualifying widow(er) with dependent child:** If your spouse died during the last two years, you have a qualifying child, and you meet certain other conditions, you may file as a qualifying widow(er) with dependent child.

Once you have determined your filing status, check the IRS tax tables for the current year. Find the table and the line that represents your taxable income for the year. Cross-reference this amount with your filing status to determine your tax amount. Table 5 shows the last few years of the tax tables for the filing status of *Married Filing Jointly* from the IRS.

**Table 5. Tax Tables for Married Filing Jointly**

Year	If Taxable Income Is Over	But Not Over	Tax Is	Plus This Percentage	of the Excess
2017	0	\$18,650	0	10%	0
	\$18,650	\$75,900	\$1,865	15%	\$18,650
	\$75,900	\$153,100	\$10,453	25%	\$75,900
	\$153,100	\$233,350	\$29,753	28%	\$153,100
2018	0	\$19,050	0	10%	0
	\$19,050	\$77,400	\$1,905	12%	\$19,050
	\$77,400	\$165,000	\$10,313	22%	\$77,400
	\$165,000	\$315,000	\$29,388	24%	\$165,000
2019	0	\$19,400	0	10%	0
	\$19,400	\$78,950	\$1,940	15%	\$19,400
	\$78,950	\$168,400	\$9,086	25%	\$78,950
	\$168,400	\$321,450	\$28,765	28%	\$168,400

The government has also set up a system to ensure that all income-earners pay some tax. There is an alternative minimum tax (AMT) that is aimed at preventing the wealthy from avoiding income taxes. For most people, this minimum tax has no effect; however, it may be significant for the wealthy. Note that this tax is becoming more and more prevalent.

**Step 5: Subtract Credits to Calculate Total Tax Owed**

Credits are different from deductions. Credits are more valuable because they are dollar-for-dollar reductions in your tax liability, whereas deductions only reduce taxable income. Credits are either refundable (paid to the taxpayer even if the amount of the credits exceeds the tax liability) or non-refundable. Refundable credits include reductions for earned income, taxes withheld on wages, and estimated income tax payments. Non-refundable credits include child tax, child and dependent care, elderly and disabled, adoption, and education. Many of these credits are phased out for taxpayers in higher income brackets. Following are credits for 2019.

*The Child Tax Credit* of \$2,000 (\$1,400 refundable) is given for each child of the household under 18 years old at the end of the year. A qualifying child is one whom the taxpayer can claim as a dependent. This credit is given and it can even become a tax refund for low-income families or a refundable credit. However, the Child Tax Credit begins to phase out after the taxpayer's income exceeds a specific amount. The amount phased out is based on the number of credits—it is not a percentage phase-out.

Education tax credits include the *American Opportunity Tax Credit* and the *Lifetime Learning Credit*. The American Opportunity Tax Credit gives parents or students a 100-percent tax credit



for the first \$2,000 paid and a 25-percent tax credit on the next \$2,000 for the first four years of college, with 40% refundable. The result is a credit of up to \$2,500 per year for the first four years of college. Qualifying expenses include tuition and books—but not room and board—at an accredited vocational school, college, or university.

After your fourth year of college, the *Lifetime Learning Credit* can be applied to offset 20 percent of the first \$10,000 for tuition and related expenses for all eligible students in the family (up to \$2,000), even for part-time students.

Taxpayers may be eligible for additional credits if they earn below a specific limit, adopt, are disabled, over 65 and have a low income, pay taxes in other countries, or overpay Social Security taxes because they work more than one job.

### **Step 6: Subtract Taxes Paid to Get Total Taxes Owed or Amount of Refund**

Once you have calculated the total tax you owe, subtract the amount of taxes you have already paid. The result will either be the amount of taxes you owe or the amount you will have refunded to you.

### **Understand the Major Tax Features and Strategies to Minimize Tax Payments (for a Given Level of Income)**

The United States tax system is structured as a progressive, or graduated, tax system. This means that increased income is taxed at increased rates. The logic behind this system is that people who earn more can afford to pay a higher percentage of their earnings in taxes. There are four major types of taxes: income, capital gains, income based, and non-income based.

### **Income Taxes**

The tax system is complicated by the fact that different types of earnings are taxed differently—a policy consistent with the government’s view that tax policy should encourage specific earning behaviors. To understand tax policies, there are three terms you should know: marginal tax rate, average tax rate, and effective marginal tax rate.

Your marginal tax rate is the percentage of the last dollar you earn that will go toward federal income taxes. This rate is important to know when you are calculating returns on various assets. Any new income will be taxed at this rate, and any additional deductions will save taxes at this rate. This rate refers to what tax bracket you are in.

Your average tax rate is the average amount out of every dollar you earn that goes toward federal income taxes. This is your overall tax rate on income earned. This rate is calculated by dividing your tax liability by your taxable income.

Finally, your effective marginal tax rate is the average amount out of every dollar you earn that is paid to all local, state, and federal income taxes. This rate is calculated by dividing your tax

liability by your total income.

**Capital Gains Taxes**

Capital gains taxes are taxes on the appreciation of an asset. Capital gains can be either short-term or long-term; these designations refer to how long you owned the asset before you sold it. This tax can also be realized or unrealized, depending on whether or not you have sold the asset. If you owned the asset for less than 12 months and then sold it, appreciation of the asset would be considered realized short-term capital gains, and the gain would be taxed at your marginal tax rate. If you owned the asset longer than 12 months before selling it, any appreciation of the asset would be considered a realized long-term capital gain.

Capital gains taxes do not perfectly match up with the tax brackets; rather, they are applied to maximum taxable income levels (000’s). Medicare taxes also change with income

**Figure 2. Tax Brackets, Capital Gains and Dividends, and Medicare Tax Rates in 2019**

Filing Single	Married		Ordinary Income	Cap. Gains & Dividends Tax Rate		Medicare Tax Rate		Total Cap Gains & Medicare
	Filing Jointly	Head of Household		Eamed Inc.*	Invest. Inc.			
-	-	-	10%	0%				
9.70	19.40	13.85	12%	0%	2.9%	0.0%	2.9%	
39.48	78.95	52.90	22%	0%	2.9%	0.0%	2.9%	
39.38	78.75	52.75		15%	2.9%	0.0%	17.9%	
84.20	168.40	84.20	24%	15%	2.9%	0.0%	17.9%	
160.73	321.45	160.70	32%	15%	2.9%	0.0%	17.9%	
204.10	408.20	204.10	35%	15%	2.9%	0.0%	17.9%	
434.55	488.85	461.70		20%	3.8%	3.8%	27.6%	
510.30	612.35	510.30	37%	20%	3.8%	3.8%	27.6%	

\* Combined rate = 1.45% employer contribution.

Unrealized capital gains taxes are postponed until you sell an asset. While you can postpone capital gains taxes, you cannot postpone taxes on distributed earnings from mutual funds or taxes on dividends from stocks and interest from bonds.

Capital gains can also be earned through home ownership. Perhaps you purchased a house years ago for \$150,000 and it is worth \$400,000 today. Gains of up to \$500,000 for couples and \$250,000 for individuals are exempt from taxes if the home is your principal residence and if you have lived there and owned the home for two of the five years preceding the sale.

**Income-Based Taxes**

The third major type of tax is income-based taxes, such FICA (Federal Insurance Contributions Act). FICA is a mandatory insurance program that is administered by the federal government to provide support to your family in the event of death, disability, health problems, or retirement.

To pay for FICA, you and your employer each pay 7.65 percent of your gross salary into the federal system, for a total of 15.3 percent. Of the 7.65 percent, 6.2 percent is paid into Social Security. The amount you pay into Social Security is capped (i.e., income over a certain limit is not taxed) and adjusted annually for inflation. The remaining 1.45 percent is paid into Medicare, a health-care insurance program for the elderly and disabled; this program has no annual cap.

You are responsible for only half of these income-based taxes unless you are self-employed, and then you must pay the entire 15.3 percent yourself.

Starting in 2013, those earning more than \$200,000 (Single filing) or \$250,000 (Married-Filing-Jointly) will be taxed an additional 0.9 percent on earned income and an additional 3.8 percent on investment income to help fund Medicare (see Figure 2). Note that companies are not responsible for contributing any additional amount to the changes to the Medicare Tax.

In addition to these taxes, there are also state income taxes and local income taxes. Local income taxes are uncommon, but some larger cities, such as New York City, impose such a tax.

### **Non–Income-Based Taxes**

Non-income-based taxes include sin taxes, excise taxes, and state sales tax. These taxes are imposed when goods are purchased. This category also includes real estate and property taxes that are imposed annually or semiannually on assets owned. Finally, there are gift and estate taxes; these taxes may be imposed when assets are transferred from one owner to another. The tax is imposed on the person transferring the assets, not the person receiving the assets.

There are four strategies to minimize your tax payments for a given level of income or to maximize after-tax income:

If your income rises above a certain level, you begin losing a percentage of your deductions. The higher your income gets, the more your allowable itemized deductions are reduced. While these calculations are complicated, be aware that these adjustments may be applicable.

### **Strategies to Minimize Tax Payments (for a Given Level of Income)**

The challenge to the taxpayer is to determine whether his or her calculated deductions are greater than the government's standard deduction. It may be to your advantage to itemize your deductions. If the government's standard deduction is greater than your itemized deduction, then it is to your advantage to take the standard deduction. Once you understand the tax system, you can utilize the deductions that minimize your tax payments and maximize the amount that is left over for your personal goals.

### **1. Maximize Your Deductions**

It is important to understand which deductions the government allows. By maximizing your deductions, you are reducing your taxable income—the amount on which your taxes are based. Suggestions for maximizing your deductions include the following:

- Use your home as a tax shelter. Interest payments on the mortgage you took out to purchase your home can be deducted from your AGI to reduce your taxable income.
- Shift and bunch your deductions to get the maximum benefit in a specified year.
- Continue to give to your church with tithes and offerings. While you do not give solely for a tax deduction, because you are already giving, you might as well get the tax deduction.
- Keep good records of all charitable contributions, including mileage and any in-kind donations to charities.
- Keep good records of health-related and moving-related expenses.

## **2. Maximize Long-Term Capital Gains and Stock Dividend Income**

A long-term capital gain is a gain on an investment asset that you hold for more than one year before selling. For example, if you bought a mutual fund for \$10 two years ago, and you sold it for \$15 this year, you have a gain of \$5. Since you held the fund for more than one year, the gain is considered a long-term capital gain. Long-term capital gains income is taxed at a lower rate than ordinary income. Try to earn as much capital gains income as possible each year (versus ordinary income).

All income is not taxed equally. Stock dividends are taxed at a preferential tax rate compared to bond interest, whereas bond and savings interest is taxed at ordinary tax rates. Qualified stock dividends are taxed at the dividend preferential rate (20, 15, or zero percent preferential rate, depending on your marginal tax rate). To see if dividends are qualified or not, see [Taxes on Security Earnings – Qualified Dividends](#) (LT32).

Here are some key suggestions:

- Focus on long-term capital gains. These are not taxed until the asset is sold.
- Maintain a long-term buy-and-hold strategy on mutual funds and stocks to defer taxes until the assets are actually sold.
- Manage your portfolio on a tax-efficient basis—it's not what you *make*, but what you *keep* after taxes and inflation that makes you wealthy.
- If your risk tolerance allows, increase your allocation to stocks, stock mutual funds, stock index funds, and ETFs since stock dividends are taxed at a lower tax rate.

## **3. Earn Tax-Exempt Income**

Tax-exempt income is excluded from your total income, meaning you do not have to pay taxes on it. Some key suggestions for using the strategy of earning tax-exempt income include the following:

- Look for tax-free investments. Municipal bond interest is free from federal tax and may be free from state and local tax as well. By investing in municipal bonds, you pay an implicit tax—the rate of return is lower than a comparable taxable bond. Depending on your marginal tax rate, it may or may not make sense to do this. Remember, the goal is to maximize your after-tax profits.
- Use medical savings accounts, also called flexible spending accounts, to pay medical bills. This way you are reducing income by paying medical bills with before-tax dollars.
- Contribute to charity by donating appreciated long-term capital assets. If you donate your appreciated assets to charity, not only do you get the full value of the donation, but you also do not have to pay the capital gains on the appreciated assets. For example, suppose you have a stock you bought for \$10 per share and it is now worth \$20 per share. If you sold it and used the income to pay your tithes and offerings, you would receive \$20 but would have to pay capital gains taxes on your \$10 gain. At a 15 percent tax rate, you would only have \$18.50 after taxes. However, if you donated the stock to your church or any qualified charity, i.e., a donation-in-kind, the church or charity receives the stock, you receive a receipt for \$20, and you do not have to pay capital gains tax on that stock. For help with this process, see [Tithing Share Transfer](#) (LT08) Example.

#### **4. Defer Taxes to the Future or Eliminate Future Taxes**

Deferring taxes to the future means that you put off paying taxes on your current income now and then pay taxes on the money when you withdraw it at retirement. The following are key recommendations:

- Invest as much as your budget will allow in your 401(k) and your other tax-deferred retirement plans, especially if they are matched accounts. Individual retirement accounts, 401(k) plans, and SEP IRA plans defer taxes to the future.
- Invest in specific-purpose investment vehicles that eliminate all future taxes. You invest in these vehicles with after-tax dollars, and if the assets are used for the purpose that you specified, you never pay taxes on the earnings again. The following are key recommendations:
  - Save for retirement using a Roth IRA or Roth 401(k) investment vehicle. Earnings on Roth investment vehicles are tax eliminated, i.e., you invest with after-tax money, and then you are not taxed on those assets ever again, as long as you take them out after age 59½.
  - Save for your children's educations using a Coverdell Education Savings Account (Education IRA) or a state 529 savings plan. You invest in these vehicles with after-tax dollars and earnings are never taxed, assuming they are used for qualified educational expenses.

- Save for your children's college-tuition expenses using government Series EE or Series I savings bonds. If the principal and interest are used to pay for college tuition, the interest is tax-free (subject to specific income limits). Focus on your rate of return and your tax rate. If your after-tax return on these vehicles is higher than you could make other places, it may be a good place to invest for your children's education.

### **Learn to Be More Efficient with Your Taxes**

Below are some ideas that may be helpful as you work toward better organization and preparation of your taxes:

- 1. Be organized with your record-keeping.** One of the difficult things about preparing your tax return is knowing where all your useful receipts are. Keep a folder that is dedicated to holding all your tax receipts over the year. Make this folder readily available. Any time you do anything that may have a tax consequence, put the receipts in that folder. An electronic system, such as Quicken or Mint.com, makes it easy to record and remember details about charitable contributions or payments toward taxes for future use.
- 2. Keep copies of the previous year's tax returns.** When preparing your taxes, review your tax returns from last year. Review your exclusions, tax deferrals, deductions, exemptions, and other areas to make sure you are not missing out on any legal tax reductions. Keep copies of all your lists of deductions and receipts so you will have the necessary backup if you are audited. You should keep copies of the last seven years of your tax returns.
- 3. Keep good records for itemizing deductions.** Keep records of things you donate to Deseret Industries, the Salvation Army, United Way, and other charitable organizations: these donations can increase your tax deductions. You should also keep good records showing what non-cash charitable contributions you make, such as miles you travel for church-related or Boy and Girl Scouts activities.
- 4. Spend time in December calculating potential investment gains and losses.** Remember, you can offset gains from your investment portfolio with your investment losses and costs, and you can deduct up to \$3,000 per year in net portfolio losses. While this may not seem like much, if you know you have \$2,000 in investment gains for the year, you could look to assets you want to sell that have investment losses; you could then sell those assets with a corresponding \$2,000 loss—thereby canceling out any increase in income from your investments and reducing your tax bill.
- 5. Make charitable contributions with appreciated long-term capital assets.** Donate to your church or charity using appreciated assets and avoid the capital gains taxes.

### **Understand and Create Your Tax Plan**

As you work on your taxes, you can see the importance of following the principles. Paying the government everything you owe, and not a penny more is critical. The following are ideas as you put your Tax Plan together, including some strategies that you will not learn until later in the course for thought purposes.

### **Vision**

- This will likely be from your “Plan for Life.” It may include:
  - Financial difficulties will not be a concern. We will have sufficient financial resources to meet the needs of our family.
  - I will live with integrity in all I do, including with my God, my family and the government.

### **Goals**

- Pay the government every penny we owe, but not a penny more.
- Show by my actions that integrity is more important than money.
- Be honest in all my dealings, including with the government.
- Use taxes strategically in developing my life and retirement plans.
- Maximize all after-tax cash flows.
- Pay all bills when due.

### **Plans and Strategies**

#### *Before Retirement*

- Keep good records for tax and other purposes.
- Every third year get help preparing your federal and state taxes to ensure you are minimizing your tax payments.
- Pay tithes and offerings with appreciated securities.
- Use appreciated securities as a strategy to rebalance your investment portfolio.
- Diversify your retirement assets into 40% tax-deferred (401k, 403b, IRA plans), 30% tax-eliminated (Roth 401k/403b/IRA), and 30% tax-now assets (brokerage accounts and banks). That way you can target your tax rate in retirement at a low rate.
- Be tax-efficient in my investment strategy.
- Do tax harvesting in December to reduce investment income.

#### *During Retirement*

- Every third year get help preparing your federal and state taxes to ensure you are minimizing your tax payments.
- Pay tithes and offerings with appreciated securities.
- Use appreciated securities as a strategy to rebalance your investment portfolio.
- While on your mission, change tax-deferred retirement accounts (401k, 403b) into Roth accounts (Roth IRA, Roth 401K) at a lower tax rate.
- Diversify your retirement assets into 40% tax-deferred, 30% tax-eliminated (Roth), and 30% tax-now assets. That way you can target your tax rate in retirement at a lower rate.

### **Constraints**

- Laziness will keep you from good record keeping.
- Not living on a budget will make it difficult to save.
- Getting caught up in the things of the world will make it difficult to save.

### **Accountability**

- You will share your vision and goals with your spouse and children.
- You will remember these things in prayer with Heavenly Father each week.

## Summary

Tax planning is a critical part of financial planning because it influences so many different areas of your personal financial life. The average American worked over 100 days last year just to pay his or her federal, state, and local taxes.

Preparing your income tax is a six-step process:

1. Determine your total or gross income from all sources, subtract your exclusions.
2. Subtract adjustments to total income; the result is your adjusted gross income .
3. Subtract the greater of your standard deduction or itemized deductions.
4. Refer to the IRS tax table and calculate your tentative tax.
5. Subtract your credits; the result is your total tax owed.
6. Subtract any taxes already paid; this leaves either the amount of your balance due or the amount of your refund.

Each of these steps is critical to correctly calculating your federal income tax.

The United States tax system is a progressive, or graduated, tax system. Increased income is taxed at higher rates. The four major taxes are income taxes, capital gains taxes, income-based taxes, and non-income-based taxes.

Tax strategies to minimize your tax payments include:

1. Maximize your deductions.
2. Maximize capital gains income.
3. Earn tax-exempt income.
4. Defer taxes to the future or eliminate future taxes.

By using these strategies effectively, you can reduce your tax liability and the amount of taxes you are legally required to pay at a given level of income.

We concluded with some ideas that may be helpful as you work toward better organization and



preparation of your taxes:

1. Be organized with your record-keeping.
2. Keep copies of the previous year's tax returns.
3. Keep good records for itemizing deductions.
4. Spend time in December calculating potential investment gains and losses.
5. Understand the major features of the U.S. tax system.

Taxes are a required part of living in the United States. However, there is no law that requires us to pay more than is legally due. By utilizing the recommendations and ideas in this chapter, you can fulfill your responsibility as a wise financial steward and legally minimize your tax payments to the government.

## Assignments

### Financial Plan Assignments

Your assignment is to put together your Tax Plan. To do this, start with your [PFP Tax Planning Template](#) (LT01-05). You must understand both the taxes you paid last year and the taxes you will pay this year. Get a copy of last year's income tax form. What form did you use (e.g., 1040A, 1040EZ, etc.)? Why did you use that form?

Think about what you are going to do differently this year in regard to your taxes. What forms are you going to use this year? What additional plans and strategies can you use to legally reduce your tax payments for a given level of income? What plans and strategies will you use going forward to pay every dollar you owe in taxes, and not a penny more?

### Learning Tools

The following Learning Tool may be helpful for tax planning..

#### [Federal Tax Liability Worksheet](#) (LT39)

This spreadsheet divides the process of tax planning into each of its component areas. You can choose your year of data, and it brings in the relevant tax tables. It can also help with your education credits and determining the amount owed or refund.

#### [Tithing Share Transfer Example](#) (LT08)

This document is an example of a form you can use to pay your tithes and other offerings with appreciated stock or mutual funds. You get the benefit of not paying capital gains on your appreciation, and you can deduct the full value of the donations on your taxes.

### Review Materials

## Terminology Review

**Bankruptcy Chapter 13.** This process prepares a repayment plan in which the court binds both the debtor and the creditors to terms of repayment. The debtor retains property and makes regular payments to a trustee out of future income to pay creditors over the life of the bankruptcy plan.

**Bankruptcy Chapter 7.** This process liquidates assets and uses them to pay creditors according to precedence in the bankruptcy code. It is the quickest, simplest and the most frequently selected (75%) kind of bankruptcy filing. Certain debts cannot be waived by Chapter 7 bankruptcy such as child support, student loans, drunk driving fines, etc.

**Carelessness.** A reason for debt. We understand its costs, but we become lazy.

**Compulsiveness.** A reason for going into debt. We lack the self-control to discipline our purchases.

**Counseling: For-profit credit counseling agencies.** These are companies whose goal is to make money through helping people get out of debt. They often consolidate debt into a single loan with a lower rate, or get homeowners into a interest-only home loan and use the excess cash to pay down debt.

**Counseling: non-profit credit counseling agencies.** These are agencies set up specifically to help people reduce the credit-card debt load in their lives. The non-profit companies have arrangements with many of the credit companies. Working with them, they can reduce or even eliminate your interest payments with specific creditors.

**Credit Counseling Agencies (CCAs).** These may be either non-profit or for-profit agencies to help you get out of debt. You should use these with caution.

**Debt.** It is the process of borrowing something with the expectation to pay it back in the future with interest.

**Debt Cycle.** It is the process of why and how we go into debt.

**Debt Elimination: Expensive Debt First.** This is one of the personal strategies. The logic is to pay off your most expensive debts first.

**Debt Elimination: Smallest Debt First.** This is one of the personal strategies. The logic is to pay of the smallest debts first. Then take the money saved to pay off all your other debts. You have success early on as you pay off the smallest debts first.

**Debt Reduction Strategies.** These are strategies for reducing debt. It is a six-step process: 1. Remember perspective, the “why’s” and “what’s.” Accept that you have a debt problem; 2. Write down your goals so you know where you want to be. Stop incurring new debt; 3. See where you are by making a list of all your bills and debts. Admit the need to change your habits and lifestyle if being debt free is important; 4. Look for one-shot ways of reducing debt; 5. Organize a debt repayment Plan; and 6. Follow through on the Plan until total debt elimination.

**Home Equity Loans.** This is a personal debt strategy. You take our a home equity loan, which is a loan against the equity in your home (the difference between what the home is worth and how much you owe on it) to pay off your debts.

**Ignorance.** A reason for going into debt. We don’t understand interest and its costs.

**Interest.** The cost of using borrowed money. Interest must always be paid,

**Necessity.** One of the reasons for going into debt. It is we truly cannot feed our families.

**Pride.** A reason for going into debt. How we look to others is more important than how we look to God.

## Review Questions

1. In regard to taxes, what is our obligation as citizens?
2. Why is tax planning important?
3. What are the seven steps to calculating your income taxes?
4. What are the four strategies to minimizing your tax payments?
5. Give five ways to help better organize and prepare your income taxes.

## Case Studies

### Case Study #1

#### Data

Matt and Janina, ages 42 and 40, are married and filling out their 2019 taxes. They have 4 children, 3 under 17 and one a dependent in college. They contributed \$5,000 to a traditional 401k in 2019, \$2,500 to a flexible spending plan, and state and local taxes were \$11,000. They can only deduct medical bills above 10% of AGI, job related expenses above 2% of your AGI, and state and local taxes less than or equal to \$10,000. The standard deduction for married filing jointly is \$24,400, and the child tax credit is \$2,000 per child under 18. Tax rates for 2019 for married filing jointly are:

\$0 to \$19,400	10%
\$19,400 to \$78,950	\$1,940 plus 12% of the amount over \$19,400
\$78,950 to \$168,400	\$9,086 plus 22% of the amount over \$78,950
Income: Earned Income	\$80,000
Interest Income	10,000
Expenses: Home mortgage interest	6,800
Un-reimbursed medical bills	9,063
Tithes and offerings	9,600

#### Calculations

Using the married filing jointly status and the information above, calculate their 2019 taxes first using the standard deduction and then using itemized deductions. Calculate their marginal tax rate and average tax rate on gross income.

#### Recommendations

Which way should they calculate their taxes? What could they do to reduce their taxes?

### Case Study #1 Answers

#### Calculations: Standard Deduction Method

1. Income from all Sources	\$90,000
Less 401k exclusion	-5,000
= Gross Income	85,000

2. Less Flexible Spending	-2,500	
= Adjusted Gross Income (AGI)	82,500	
3. Minus Standard Deduction	-24,400	
4. Minus Exemptions (6)	0	(6 * \$0)
Equals Taxable income	58,100	
5. Look up tax in tax table:		
Tax:	1,940	10% on first \$19,400
	4,644	12% on remainder
Tentative tax	\$6,584	
6. Child tax credit	-6,500	(3 * \$2,000) + \$500 family credit
7. Total Tax Due	\$84	

**Calculations: Itemized Deduction Method**

1. Gross Income	\$85,000	(Earned + Interest – 401k exclusion)
less Flexible Spending	-2,500	
2. Adjusted Gross Income	82,500	
3. Deductions		
Home Mortgage Interest	6,800	
Medical Expenses	813	(\$9,063-(82,500*.10)
State and local taxes	10,000	(\$10,000 max)
Tithing	9,600	
Total Deductions	27,213	
4. Minus Income Exemptions	0	(6 ex. *0)
Equals Taxable income	55,287	
5. Look up Tax in Table	1,940	10% on first \$19,050
\$55,287-19,400 *.12	4,306	2% on remainder
Calculated tentative tax	\$6,246	
6. Child tax credit	-6,500	(2,000 * 3 kids under 18)
= Total Taxes Due	-\$254	

Since \$1,400 per child is refundable, he will get a refund of the \$254.

Calculations: Calculate their marginal and average tax rate on gross income.

Their marginal tax rate, the tax rate they would pay on each new dollar of income is 15% for both the standard and itemized deduction calculation.

Their average tax rate, the rate they actually pay in taxes is their taxes divided by their gross income.

$$\text{Standard deduction} = \$84 / \$85,000 = 0.1\%$$

$$\text{Itemized deduction} = \$0 / \$85,000 = 0\%$$

As a check, Federal Tax Worksheet (LT39) may be helpful.

## Chapter 4. Taxes: Paying All You Own and Not a Penny More

Federal Tax Liability Worksheet (LT39) <small>Use Drop Down Box</small>		Federal Tax Liability Worksheet (LT39) <small>Use Drop Down Box</small>	
Clear Inputs		Clear Inputs	
Sudweeks January 25, 2019		Sudweeks January 25, 2019	
Year & Status 2019 Married Filing Jointly		Year & Status 2019 Married Filing Jointly	
<b>Note: Using 2019 Tax Rates for Married Filing Jointly</b>			
<b>Step 1: Determine Total Income</b>			
Includes:		Amounts	
Wages, salaries, tips	80,000		
Investment interest income/bonus	10,000		
Education income in excess of expenses			
Excludes:			
Qualified retirement contributions (401k, 403b, not Roth's)	5,000		
Interest on US Savings bonds			
<b>Total Gross Income</b>		<b>85,000</b>	
<b>Adjusted Gross Income</b>			
Excludes:			
Tuition & Fees and Student Loan interest Deduction**			
IRA/SEP contributions (not Roth IRA)			
Medical Savings Account contributions			
Flexible Spending Account contributions	2,500		
<b>Total Adjusted Gross Income</b>		<b>82,500</b>	
<b>Step 2: Calculate Taxable Income</b>			
<b>Standard or Itemized Deductions</b>			
Standard			
Standard deduction	24,400		
<b>Itemized deductions</b>		<b>27,213</b>	
Charitable contributions			
State and Local Taxes (SALT \$10,000 max.)			
Home mortgage interest			
Other taxes			
Charitable Mileage	0.14		
Job Related - Not Deductible in 2018			
Medical expenses > 10.0% of AGI	8,250		
<b>Total itemized deductions</b>		<b>27,213</b>	
<b>Total Taxable Income</b>		<b>55,287</b>	
<b>Step 3: Determine Tax Liability for 2019 for Married Filing Jointly</b>			
10%	19,400	1,940	
12%	19,400	78,950	4,306
22%	78,950	168,400	-
24%	168,400	321,450	-
32%	321,450	408,200	-
35%	408,200	612,350	-
<b>Total Tax Liability</b>			<b>6,584</b>
<b>Step 4: Calculate Tax Due or Tax Refund</b>			
	Maximum	Total Credits	Refundable
Family Credits (non-refundable)*	1	500	500
Lifetime Learning Credit (non-refund.)			
Child Tax Credit (<17, partial, refund.)*	3	2,000	4,200
American Opport. Credit (Partial)*			
American Opport. Credit (Partial)*			
<b>Total Tax Credits / Total Refundable</b>		<b>6,500</b>	<b>4,200</b>
<b>Tax Liability after Credits</b>			<b>84</b>
<b>Amount Withheld (withholdings - including refundable credits)</b>			
<b>Total Taxes Due (Refund)</b>			<b>84.00</b>
Marginal Tax Rate:			<b>12.00%</b>
Average Tax Rate on Gross Income			<b>0.10%</b>

### Recommendations

#### Method:

Using the Itemized versus the standard deduction nets a savings of \$338 over the standard deduction. Matt and Janina should use the itemized method as they have more money for their goals

What could they do to reduce their taxes?

There are lots of different answers you could give; however, you do not have specific data in the case that leads to any specific recommendation. Following are a few assumptions and ideas:

#### 1. Maximize Deductions

- They should keep records of their home interest payments, state and local taxes (up to \$10,000) and property taxes which are deductible. Property taxes were not in the case.
- If they are involved in charity, they could deduct the miles they drive to and from the charity.
- If they have non-cash contributions such as donations to Deseret Industries or Goodwill, they could keep good records of these donations.
- If they have appreciated financial assets they could contribute these to charity instead of cash, reducing taxes paid, increasing deductions and eliminating capital gains taxes.
- They could keep having kids.

#### 2. Minimize Taxes Owed

- If they have investments, they could use a passive strategy and purchase low-turnover mutual funds to minimize their mutual fund distributions (and taxes), increase long-term capital gains (rate depends on their taxable and AGI income).
  - If they invest in stocks or stock mutual funds, stock dividends are taxed at a preferential rate versus bond interest at their marginal tax rate.
3. Receive tax-exempt income
- If their work has a flexible spending plan (FSP), they could contribute to their FSP to pay medical bills with pre-tax dollars and reduce their AGI. In this case, they should have a larger FSP.
  - If they have investments, they could invest in municipal bonds which are federal tax-free for interest, or Treasury securities which are state tax-free.
4. Defer taxes to the future or eliminate future taxes altogether
- If they have qualified plans at work, they could contribute to a 401k/403b/457 plan. This plan would reduce their AGI and may have a match.
  - They have kids so they could contribute to 529 and Education IRA plans which would have no tax advantages now but eliminate taxes on their earnings in the future.
  - If available, they could use a Roth 401k or Roth 403b, which may have a match, and never pay taxes on these earnings again.

## Case Study #2

### Data

Your friend Brian, a financial analyst, comes to you with this sure-fire method of reducing taxes. He says that if you buy into this product (this product can be many different types of tax-schemes), you will not have to pay taxes on the earnings and it will save you taxes as well. It doesn't sound right, so Brian comes and asks:

### Application

To what lengths should you go to avoid taxes?  
Where should your best tax advice come from?

### Case Study #2 Answer

Any legal method. However, if it seems too good to be true, it probably is, so get another opinion. It's not worth losing your integrity or going to prison over bad tax advice. You are ultimately responsible for your choices and for paying taxes. Where you get your tax advice, and how and what you pay for your taxes and other obligations is your choice and responsibility. Your best tax advice should come from those who make it a business of giving tax advice. In addition, the IRS has many publications which can help you as you determine the taxes you should pay.

Case Study #3<sup>3</sup>

Data

David and Jenny have four children: Aaron (20), Brittany (18), Camden (16), and Dannie (14). David earned \$110,000, and a \$10,000 bonus, and had \$12,000 withheld for federal income taxes, \$6,000 for Utah State income taxes, and \$9,180 for payroll taxes. They earned \$100 interest. They saved \$12,000 in a Roth 401k and \$5,000 in a traditional IRA. They \$13,000 in tithes and offerings, \$6,000 in Utah state taxes, \$4,500 in property taxes, and \$4,200 in qualified home mortgage interest. They paid \$4,000 in unreimbursed medical costs when Dannie broke her arm. Aaron is a missionary in Peru, and they contributed \$400 each month to the Church for his expenses. Brittany just completed a semester at BYU Idaho, with expenses of \$4,700 (\$2,000 tuition, \$300 books, and \$1,600 housing and \$800 food). (Sorry but a mission does not count for a family credit)

Recommendations

Based on the facts below, help the Petersons determine if they should itemize or use the standard deduction? Will they have to pay more taxes or will they get a refund? How much?

**Case Study #3 Answers**

**Calculations: Standard Deduction Method**

1. Gross Income	\$120,100	
2. Less IRA contribution	-5,000	
= Adjusted Gross Income (AGI)	115,100	
3. Minus Standard Deduction	-24,400	
4. Minus Exemptions (6)	0	(6 * \$0)
Equals Taxable income	90,700	
5. Look up tax in tax table:		
Tax:	1,940	10% on first \$19,400
	7,146	12% on the next bracket
	<u>2,858</u>	22% on remainder
Tentative tax	\$11,671	
6. Child tax credit	-4,500	(2 * \$2,000) + \$500 family credit
AO Credit	<u>-2,075</u>	(100% of \$2k + 25% up to \$4k)
7. Total Tax Due	\$5,096	
Taxes Paid	12,000	
Refund	-\$6,904	

**Calculations: Itemized Deduction Method**

1. Gross Income	\$120,100
2. Less IRA contribution	-5,000
= Adjusted Gross Income (AGI)	115,100
3. Deductions	
Home Mortgage Interest	4,200

## Chapter 4. Taxes: Paying All You Own and Not a Penny More

Medical Expenses	0	(\$4,000-(115,100*.075))
State and local taxes	10,000	(\$10,000 max)
Tithing	17,800	(13,000 + \$400*12)
<b>Total Deductions</b>	<b>\$32,000</b>	
4. Equals Taxable income	83,100	
5. Look up Tax in Table	1,940	10% on first \$19,050
	7,146	12% on \$58,350
	<u>913</u>	22% on \$5,700
Calculated tentative tax	\$9,999	
6. Child tax credit	<u>-6,575</u>	(2,000 * 3 kids under 18)
7. Total Taxes Due	\$3,424	
Amount withheld	12,000	
Refund is	-\$8,576	

Federal Tax Liability Worksheet (LT39) <span style="float: right;">Use Drop Down Box</span>			
Clear inputs	Year & Status: 2019 Married Filing Jointly		
<b>Note: Using 2019 Tax Rates for Married Filing Jointly</b>			
<b>Step 1: Determine Total Income</b>			
Includes:	Amounts		
Wages, salaries, tips	110,000		
Investment interest income/bonus	10,100		
Education income in excess of expenses	-		
Excludes:	-		
Qualified retirement contributions (401k, 403b, not Roth's)	-		
Interest on US Savings bonds	-		
<b>Total Gross Income</b>	<b>120,100</b>		
<b>Adjusted Gross Income</b>	<b>115,100</b>		
Excludes:	-		
Tuition & Fees and Student Loan interest Deduction**	5,000		
IRA/SEP contributions (not Roth IRA)	-		
Medical Savings Account contributions	-		
Flexible Spending Account contributions	-		
<b>Total Adjusted Gross Income</b>	<b>115,100</b>		
<b>Step 2: Calculate Taxable Income</b>			
<b>Standard or Itemized Deductions</b>	Standard = 24,400		
Standard deduction	24,400		
<b>Itemized deductions</b>	-		
Charitable contributions	17,800		
State and Local Taxes (SALT \$10,000 max.)	16,180		
Home mortgage interest	10,000		
Other taxes	4,200		
Charitable Mileage	0.14		
Job Related - Not Deductible in 2018	-		
Medical expenses > 10.0% of AGI	4,000		
<b>Total itemized deductions</b>	<b>32,000</b>		
<b>Total Taxable Income</b>	<b>83,100</b>		
<b>Step 3: Determine Tax Liability for 2019 for Married Filing Jointly</b>			
10%	19,400	1,940	
12%	78,950	7,146	
22%	168,400	2,585	
24%	321,450	-	
32%	408,200	-	
35%	612,350	-	
<b>Total Tax Liability</b>	<b>11,071</b>	<b>11,071</b>	
<b>Step 4: Calculate Tax Due or Tax Refund</b>			
Family Credits (non-refundable)*	1	500	300
Lifetime Learning Credit (non-refund.)	-	-	-
Child Tax Credit (<17, partial, refund.)*	2	2,000	4,000
American Opport. Credit (Partial)*	2,300	4,000	2,075
<b>Total Tax Credits - Total Refundable</b>	<b>6,575</b>	<b>6,575</b>	<b>3,650</b>
<b>Tax Liability after Credits</b>	<b>5,096</b>	<b>5,096</b>	<b>5,096</b>
<b>Amount Withheld (withholdings - including refundable credits)</b>	<b>12,000</b>	<b>12,000</b>	<b>12,000</b>
<b>Total Taxes Due (Refund)</b>	<b>(8,904.00)</b>	<b>(8,904.00)</b>	<b>(8,904.00)</b>
Marginal Tax Rate:	22.00%	22.00%	22.00%
Average Tax Rate on Gross Income	4.24%	4.24%	4.24%

### Case Study #4<sup>4</sup>

#### Data

Steve and Stella are a young married couple with a baby. Steve earned \$6,000 and Stella \$10,000. \$2,000 was withheld from their paychecks for federal income taxes, and they will take the standard deduction for MFJ. They learned about IRAs in Fin418, so they set up and contributed \$200 to a Roth IRA. They had tuition costs of \$10,400 and books of \$600, equally split. They received federal Pell grants worth \$6,000 in 2019 equally split.

Calculate their:

- AGI (Step 1)
- Taxable Income (Step 2)



- Tax Liability (Step 3)
- Taxes Due/(Refund)\* (Step 4)

#### Case Study #4 Answers

Calculate their AGI:

- Their AGI is composed of their gross income less any adjustments. Their gross and adjusted gross income is: \$16,000

Calculate their Taxable Income:

- Since they took the standard deduction (\$24,400) and only made \$16,000, their taxable income is: 0

Calculate their tax liability:

- Since their taxable income is \$0, their tax liability is: 0

Calculate their refund:

- The child tax credit is \$2,000, of which \$1,400 is refundable
- They have a Pell grant of \$6,000, equally split, with books and tuition also equally split.
- Their total education expenses for tuition and books was \$11,000, less the Pell grant of \$6,000, would result in tuition and book expenses, in excess of the Pell grant, of \$5,000 each.
- Since it was equally split and both are going to school, we do two American Opportunity Credits using \$2,500 of expenses for each. This results in two credits of \$2,125 of which 40% (\$850) is refundable.
- Their total credits were \$6,250, of which \$3,100 is refundable
- Their total refund would be the \$3,100 of refundable credit, plus the \$2,000 they paid, for a total refund of \$5,100

From the Vita (volunteer income tax assistance) Lab, a tax lab for students, they would recommend that since the credits are more important and you have no taxable income

- Take \$3,000 and put it in gross income. Your taxable income is still 0
- Recognizing the \$3,000 in income allows you to put \$4,000 each in the AOC credit, which brings up your total refundable credit to \$3,400
- Your refund is \$5,400, \$300 more than calculated earlier

For BYU students, we recommend when you are doing your taxes that you go to the VITA Lab for help. You can sign up at <http://www.vita.byu.edu> and set up an appointment

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<sup>1</sup> Tax freedom day is the day the average tax payer has covered all their federal and state taxes for the year. See Tax Foundation, Washington, D.C., <https://taxfoundation.org/tax-freedom-day-2018>, June 30, 2019).

<sup>2</sup> Doctrine and Covenants 58:21–22.

<sup>3</sup> Used with permission of E. Jeffrey Hill and Craig Israelson, Fundamentals of Family finance: Living Joyfully within your Means Workbook, BYU Press, 2016, updated with new tax data.

Tax Foundation, Washington, D.C., <https://taxfoundation.org/tax-freedom-day-2018>, June 30, 2018).

<sup>4</sup> Used with permission of E. Jeffrey Hill and Craig Israelson, Fundamentals of Family finance: Living Joyfully within your Means Workbook, BYU Press, 2016, updated with new tax data.