

The Federal Income Tax Return



TPSE WS 1980, p39. ES80A39

Meet John Q. Sailor, our guinea pig for examining tax transactions and how they affect us as taxpayers. John is 32, single, earned \$61,000 last year sailing and collected \$14,620 in vacation pay. John withheld a total of \$12,130 in Federal Taxes and is hoping for a refund.

We're going to make John a Massachusetts resident and every tax we examine will be calculated for tax year 2006.

Form 1040 U.S. Individual Income Tax Return 2006		(99) IRS Use Only — Do not write or staple in this space																	
For the year Jan 1 - Dec 31, 2006, or other tax year beginning 2006, ending 20		OMB No. 1545-0047																	
Label (See instructions.)	Your first name MI Last name JOHN SAILOR	Your social security number 123-45-6665																	
Use the IRS label. Otherwise, please print or type.	If a joint return, spouse's first name MI Last name	Spouse's social security number																	
Home address (number and street). If you have a P.O. box, see instructions.	Apartment no.	You must enter your social security number(s) above.																	
31 NEW LANE		Checking a box below will not change your tax or refund.																	
City, town or post office. If you have a foreign address, see instructions.	State ZIP code	<input type="checkbox"/> You <input type="checkbox"/> Spouse																	
NORWOOD MA 02062																			
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund? (see instructions)																			
Filing Status	<input checked="" type="checkbox"/> 1 Single <input type="checkbox"/> 2 Married filing jointly (even if only one had income) <input type="checkbox"/> 3 Married filing separately. Enter spouse's SSN above & full name here <input type="checkbox"/> 4 Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here <input type="checkbox"/> 5 Qualifying widow(er) with dependent child (see instructions)																		
Check only one box.																			
Exemptions	<input checked="" type="checkbox"/> 6a Yourself. If someone can claim you as a dependent, do not check box 6a <input type="checkbox"/> 6b Spouse c Dependents: <table border="1"> <thead> <tr> <th>(1) First name</th> <th>Last name</th> <th>(2) Dependent's social security number</th> <th>(3) Dependent's relationship to you</th> <th>(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see instrs.)</th> <th><input type="checkbox"/> if lived with you <input type="checkbox"/> did not live with you due to divorce or separation (see instrs.)</th> <th><input type="checkbox"/> Dependents on file not entered above</th> <th><input type="checkbox"/> Add numbers on lines above</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table> d Total number of exemptions claimed 1			(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see instrs.)	<input type="checkbox"/> if lived with you <input type="checkbox"/> did not live with you due to divorce or separation (see instrs.)	<input type="checkbox"/> Dependents on file not entered above	<input type="checkbox"/> Add numbers on lines above								
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If more than four dependents, see instructions.																			
Income	7 Wages, salaries, tips, etc. Attach Form(s) W-2 75,620. 8a Taxable interest. Attach Schedule B if required b Tax-exempt interest. Do not include on line 8a 9a Ordinary dividends. Attach Schedule B if required b Qualified dividends (see instrs.) 10 Taxable refunds, credits, or offsets of state and local income taxes (see instructions) 11 Alimony received 12 Business income or (loss). Attach Schedule C or C-EZ 13 Capital gain or (loss). Att Sch D if reqd. If not reqd, do here 14 Other gains or (losses). Attach Form 4797 15a IRA distributions b Taxable amount (see instrs) 16a Pensions and annuities b Taxable amount (see instrs) 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 18 Farm income or (loss). Attach Schedule F 19 Unemployment compensation 20a Social security benefits b Taxable amount (see instrs) 21 Other income 22 Add the amounts in the far right column for lines 7 through 21. This is your total income 75,620.																		
Attach Form(s) W-2 here. Also attach Forms W-2g and 1099-R if tax was withheld. If you did not get a W-2, see instructions.																			
Adjusted Gross Income	23 Archer MSA deduction. Attach Form 8883 24 Certain business expenses of reservists, performing artists, and fee-based government officials. Attach Form 2106 or 2106-EZ 25 Health savings account deduction. Attach Form 8889 26 Moving expenses. Attach Form 3903 27 One-half of self-employment tax. Attach Schedule SE 28 Self-employed SEP, SIMPLE, and qualified plans 29 Self-employed health insurance deduction (see instructions) 30 Penalty on early withdrawal of savings 31a Alimony paid b Recipient's SSN 32 IRA deduction (see instructions) 33 Student loan interest deduction (see instructions) 34 Jury duty pay you gave to your employer 35 Domestic production activities deduction. Attach Form 990 36 Add lines 23 - 31a and 32 - 35 37 Subtract line 36 from line 22. This is your adjusted gross income 75,620.																		

From the start, we see that John has a gross income of \$75,620 (line 7). John's Adjusted Gross Income (AGI) (line 37) is the same as line 7. Adjusted gross income is an extremely important concept. Most phase outs are calculated from this number (child tax credits, student loan interest, alternative minimum tax, etc...) The lower the AGI, the more benefits and fewer penalties.

Line 40 identifies (itemized OR standard) deduction. This is one or the other. If your itemized deductions EXCEED your standard deduction of \$5,150 in this case, you will itemize. In this example, John does not have enough deductions to itemize, so he will take the standard deduction.

Your itemized or standard deduction is subtracted from your adjusted gross income.

Exemptions (line 42) are essentially calculated by multiplying the number of exemptions (husband, wife, dependants) times \$3,300 per exemption. In John's case,

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Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	75,620.
39a	Check <input type="checkbox"/> You were born before January 2, 1942. <input type="checkbox"/> Spouse was born before January 2, 1942. <input type="checkbox"/> Blind. <input checked="" type="checkbox"/> Total boxes checked <input checked="" type="checkbox"/> 39a			
Standard Deduction for	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	5,150.
41	Subtract line 40 from line 38		41	70,470.
42	If line 38 is over \$12,875, or you provided housing to a person displaced by Hurricane Katrina, see instructions. Otherwise, multiply \$3,300 by the total number of exemptions claimed on line 6d		42	3,300.
43	Taxable income. Subtract line 42 from line 41.		43	67,170.
44	Tax (see instrs). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972		44	13,351.
45	Alternative minimum tax (see instructions). Attach Form 6251		45	
46	Add lines 44 and 45		46	13,351.
47	Foreign tax credit. Attach Form 1116 if required.	47		
48	Credit for child and dependent care expenses. Attach Form 2441	48		
49	Credit for the elderly or the disabled. Attach Schedule R	49		
50	Education credits. Attach Form 8863	50		
51	Retirement savings contributions credit. Attach Form 8880	51		
52	Residential energy credits. Attach Form 5695	52		
53	Child tax credit (see instructions). Attach Form 8801 if required	53		
54	Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8839 c <input type="checkbox"/> Form 8839	54		
55	Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Form 8801	55		
56	Add lines 47 through 55. These are your total credits	56		
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0-	57		13,351.
58	Self-employment tax. Attach Schedule SE	58		
59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	59		
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60		
61	Advance earned income credit payments from Form(s) W-2, box 9	61		
62	Household employment taxes. Attach Schedule H	62		
63	Add lines 57-62. This is your total tax	63		13,351.
Payments	64	Federal income tax withheld from Forms W-2 and 1099	64	12,100.
65	2006 estimated tax payments and amount applied from 2005 return	65		
66a	Earned income credit (EIC)	66a		
67	Excess social security and tier 1 RRTA tax withheld (see instructions)	67		
68	Additional child tax credit. Attach Form 8812	68		
69	Amount paid with request for extension to file (see instructions)	69		
70	Payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	70		
71	Credit for federal telephone excise tax paid. Attach Form 8913 if required	71		30.
72	Add lines 64, 65, 66a, and 67 through 71. These are your total payments	72		12,130.
Refund	73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you overpaid	73	
74a	Amount of line 73 you want refunded to you. If Form 8888 is attached, check here <input type="checkbox"/>	74a		
75	Amount of line 73 you want applied to your 2007 estimated tax	75		
Amount You Owe	76	Amount you owe. Subtract line 72 from line 63. For details on how to pay, see instructions	76	1,221.
77	Estimated tax penalty (see instructions)	77		

Do you want to allow another person to discuss this return with the IRS (see instructions)? Yes. Complete the following. No

Third Party Designee: Designer's name _____ Phone no. _____ Personal identification number (PIN) _____

Sign Here: Your signature _____ Date _____ Your occupation: **MERCHANT MARINER** Daytime phone number _____

Spouse's signature: If a joint return, both must sign. _____ Date _____ Spouse's occupation _____

Preparer's signature _____ Date _____ Check if self-employed Preparer's SSN or PTIN _____

Self-Prepared

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he doesn't have a wife or children, so he receives one exemption of \$3,300. Your exemptions are subtracted from AGI.

After subtracting his standard deduction and exemption, John's taxable income (line 43) is \$67,170.

Next we calculate John's tax. We pull out the IRS tax tables and they tell us for a taxable income (TI) of \$67,170, we apply a tax of \$4,220 plus 25% of any amount over \$30,650. This gives us a tax (line 63) of \$13,351. In this example, John also has a telephone excise credit (line 71) of \$30. Unfortunately, John didn't withhold enough (line 72) and will have an amount due (line 76) of \$1,221.

Looks like he won't be using his refund to buy that Bobcat he wanted...

Understanding your Marginal Tax Rate (MTR)



There are two very important tools used in examining your tax scenario for planning purposes.

First is your Effective Tax Rate (ETR). Your ETR is how you are taxed overall. John had a tax of \$13,351 on \$75,620 in income. If we divide the tax by income, we get an effective tax rate of 17.66%. This is how John was taxed on his overall return.

Second is your Marginal Tax Rate (MTR). Your MTR is how you will be taxed on the next dollar you earn. Remember the IRS tables said "we apply a tax of \$4,220 plus 25% of any amount over \$30,650". John's MTR is 25% (as we add income, he will be taxed on that income at 25%). If we added \$1 in income, it would cost us a quarter. This (MTR) is John's tax bracket as well.

Why is MTR important?

The higher our MTR, the less income we want to recognize (claim on our taxes). Currently our highest MTR is 35%. As our income increases substantially, we enter a higher tax bracket and our MTR changes. It is important to either deduct (using itemized deductions), exclude (change the character of the income to a form that is not taxed), or defer (push the recognition of income to a later date).

Easy example – 1

John had gone to the union hall on December 27 of 2006 and applied for vacation. Now let's say he waited until January 3 of 2007 to apply for vacation. John could have deferred recognizing \$14,620 in vacation pay for an entire year! John's MTR is 25%. That would have reduced his tax by \$3,655. If John had waited one week he would have had the benefit of that money for an entire year longer before recognizing it on his tax return. John would have had almost \$1,000 in refund money towards that Bobcat!

Easy example – 2

John didn't make any contributions to his 401(k). 401(k) contributions can be excluded from taxable income. If John had put \$5,000 into his 401(k), he would have fallen into the refund range. John would also get to have this contribution grow tax free until it is withdrawn.

In Summary

This is a simple start. These are very important concepts. In future articles, we will build upon this. We will note individual (just from the one article), and overall (incorporating techniques in other articles) summaries at the end of each article. We'll see that no single deduction is the answer.

It's in the plan!

Individual Summary

Gross Income – \$75,620
Taxable Gross Income - \$75,620
Adjusted Gross Income – \$75,620
Standard/Itemized Deduction – \$5,150
Tax – \$13,351

Original Tax - \$13,351
Percent Difference – 0%

Overall Summary (with example 2 only)

Gross Income – \$75,620

Taxable Gross Income - \$70,620

Adjusted Gross Income – \$70,620

Standard/Itemized Deduction – \$5,150

Tax – \$12,101

Original Tax - \$13,351

Percent Difference (tax savings) – 9.4%