

## **The Basics of Income Taxes**

For 100 years, Americans have been paying federal income taxes. In return, the government has defended our freedom, built highways, preserved natural resources and funded programs that have helped all Americans. Over those same years, the income tax law itself and the rules surrounding the law have become huge, complex and confusing. Many have found that professional income tax advisors or software programs are essential for preparing tax returns and just dealing with all the financial issues associated with income taxes.

This article does not replace the expert advice of professionals, but rather explains some of the basics so you can better understand how our income tax structure works, how it can affect your financial decisions and how you can be a more-informed income taxpayer.

Our income tax system is generally described as a progressive, marginal rate system. This means that as we earn more income, we pay higher rates of tax on that income. To better understand this, consider the following three components – how much is taxed, what tax rates apply and how do we pay the tax. Then, unfortunately, there are all the additional rules.

### **How much is taxed – or what is taxable income?**

When you prepare your tax return (Form 1040), or gather information for your return accountant, you probably start by identifying all your income for the year. This includes your wages (reported on Form W-2 and supplied by your employer), dividends and interest (reported on Form 1099 and supplied by your bank, credit union, brokerage firm and others), any capital gains you had during the year (determined your own records or supplied by a mutual fund or brokerage firm) and income from self employment, retirement plan distributions, Social Security income and other sources. You then get reductions for deductible IRA or retirement plan contributions and a couple other items.

The next step is to determine your deductions. The tax law allows itemized deductions for state and local taxes up to \$10,000, interest paid on mortgages with some limits, charitable contributions, medical expenses that exceed certain levels and a few other items. If you do not have large amounts of itemized deductions, you can take a “standard deduction.” After all the needed calculations, you arrive at your “taxable income.”

### **How is your taxable income taxed?**

There are different tax rate schedules depending on your filing status. Most taxpayers fall into the categories of “Single” filers or “Married Filing Jointly” filers. Here are the tax rate schedules for single and joint returns for 2020.

#### **Income Tax Rate Schedules for 2020**

<b>2020 Single Return Rate Schedule</b>		<b>2020 Married Filing Jointly Rate Schedule</b>	
<b>Taxable income levels</b>	<b>Tax rate</b>	<b>Taxable income levels</b>	<b>Tax rate</b>
0 to \$9,875	10%	0 to \$19,750	10%
\$9,876 to \$40,125	12%	\$19,751 to \$80,250	12%

\$40,126 to \$85,525	22%		\$80,251 to \$171,050	22%
\$85,526 to \$163,300	24%		\$171,051 to \$326,600	24%
\$163,301 to \$207,350	32%		\$326,601 to \$414,700	32%
\$207,351 to \$518,400	35%		\$414,701 to \$622,050	35%
Over \$518,401	37%		Over \$622,051	37%

## 2020 Taxation of Dividends and Long Term Capital Gains

Long term capital gains and qualifying dividends receive favorable tax treatment, based on taxable income levels.

Tax rate on long term capital gains and qualifying dividends	Taxable income levels for those filing individual returns	Taxable income levels for those filing joint returns
0%	Under \$40,001	Under \$80,001
15%	\$40,001 to \$441,450	\$80,001 to \$496,600
20%	Over \$441,451	Over \$496,601

Depending on your situation, there may also a few “credits” that can be applied to reduce your taxes for things like foreign taxes and certain education expenses. The net result is your income tax liability for the year.

### Paying your income taxes

Your employer withholds federal income taxes from your paychecks and forwards those funds to the government. This is reflected in your Form W-2 along with your earnings and Social Security withholding. The amount of income tax they withhold is based on the Form W-4 on which you identify the number of “exemptions” you claim. The larger the number of exemptions, the less they withhold.

Some individuals also end up making quarterly estimated income tax payments if they suspect their withholding will not be sufficient. There can be interest and penalties if the total of your withholding and estimated payments are too little.

You then compare your income tax liability with the total payments you have already made and the difference is what you owe or the amount of refund you should receive.

### Other issues

This article has only provided some of the very basics of our income tax laws. The Alternative Minimum Tax, special distributions from retirement plans, stock options, changes in marital status are just a few of the hundreds, if not thousands, of other issues that can complicate your situation.

Each person’s situation is different, the rules are complex and the consequences of not following the rules can be severe. Be sure you get the tax advice you want and need from a qualified professional.