Unbiased Financial Information Provided by Financial Wisdom.

Fundamentals of Income Taxes

Federal Income Taxes – A simple concept with very complicated details
Our federal income tax system was implemented in 1913 simply as a way for the government to collect revenue. Since then, the laws have been expanded and revised dozens, if not hundreds of times. If history is any guide, you can expect the tax laws to continue to change and probably get even more complex.

While you probably do not want to spend the time and effort to become an income tax expert, by understanding some of the basics you can make better financial decisions and remove some of the anxiety surrounding this financial fact of life. Everyone's tax situation can be different and this article covers only some of the basics. If your situation is complicated or if you feel that you need an expert to help with your taxes, do not hesitate to use the services of a professional.

The very, very basics
1. You add up your income. Most types of income (wages, interest, dividends, and capital gains) are included.
2. Perhaps, you then make certain adjustments. These adjustments are usually for certain IRA contributions and business expenses.
3. You then subtract either a standard deduction (set by the government) or the total of your itemized deductions (state and local taxes, charitable contributions, mortgage interest, with some limits).
4. This leaves you with your taxable income.
5. You then apply a series of tax rates to certain levels of taxable income. Higher income gets taxed at higher rates.
6. You then compare your calculated tax with the taxes that have been withheld from your paychecks (and additional estimated tax payments you may have made).
7. The difference is what you owe when you file your return on April 15th or what you will receive as a refund.

A few more details
<u>Income subject to tax</u> – Most of the income you receive by working or by investing is taxable. Along with the items mentioned above, distributions from retirement plans (unless rolled into an IRA), lottery winnings, rental income, alimony and business income are taxable. However, interest from municipal bonds is usually not taxable. Dividends and long term capital gains (from investments held for more than a year) are taxed at a lower rate than other income.

<u>Adjustments</u> – If you are not eligible to participate in a company sponsored retirement plan or if your adjusted gross income is below a certain level, contributions to a regular IRA are deductible. The current limit on IRA contributions is $6,000 for those under age 50 and $7,000 for those ages 50 and above. You may also be eligible to make adjustments for certain educational and business expenses.

Deductions – You are allowed to reduce your income subject to tax for certain types of expenses, including state and local income taxes, charitable contributions, mortgage interest and medical expenses in some cases. There are limitations on state and local taxes and some mortgage interest deductions. If you do not have these expenses or if your level of these expenses is low, the law provides a standard deduction. For 2020, the standard deduction is $12,400 for individuals and $24,800 for married couples filing joint returns.

Tax rates – Our tax system has progressive marginal tax rates. That means that income at lower levels is taxed at lower rates and income at higher levels is taxed at higher rates. There are also different rates for those that file individual returns and those married couples filing joint returns.

Income Tax Rate Schedules for 2020

2020 Single Return Rate Schedule			**2020 Married Filing Jointly Rate Schedule**	
Taxable income levels	**Tax rate**		**Taxable income levels**	**Tax rate**
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

Filing your returns – You must file your income tax return by April 15th each year. There are some rules that enable you to get an extension of time, but most people file by the due date. Getting an extension does not allow you to delay paying any taxes you may owe. For most people, the taxes that are withheld from their paychecks cover what they owe or come very close. If you have a relatively large amount of investment or other income, you may want to consider making estimated payments throughout the year to avoid owing any penalties or interest.

Being tax sensitive, not tax foolish

No one wants to pay any more tax than what they are legally required to pay. The expenses of owning a home can provide itemized deductions and contributions to your company retirement plan or IRA can also reduce your taxes. But be sure to not let the idea of saving taxes cause you to make financial mistakes.