Chapter 1

Introduction to Taxation, the

Income Tax Formula, and

Form 1040

**Learning Objectives**

LO 1. Understand progressive, proportional, and regressive tax structures

LO 2. Understand the concepts of average and marginal tax rates as well as a simple income tax formula.

LO 3. Understand the components of a simple Form 1040 income tax return.

LO 4. Determine tax liability in instances when a Form 1040 return is appropriate.

LO 5. Understand the types of tax authority and how they interrelate (Appendix A).

LO 6. Understand the provisions of IRS Circular 230 for paid tax preparers (Appendix B).

**Topics of Primary Importance**

* Determination of taxable income.
* Calculation of tax liability.
* The types of tax authority and relative strengths.

**Student Confusion Areas**

* Understanding tax terminology and the precision inherent in terminology.
* The difference between marginal tax rates and average tax rates.
* The tax refund or amount owed is simply the amount to “settle up” with the IRS. It does not represent the amount of total tax liability.

**Note to Instructor**

We have designed this text to be used with the TaxACT software and you can easily incorporate the software in your instruction and student homework. ***Alternatively*,** you can choose to ignore the software and have students use IRS forms and calculate returns by hand. Some instructors require students to calculate returns by hand for the first three to five chapters and then switch to the software. You have complete flexibility.

**If you have your students use the software, make sure you require them to update their software using the online update feature of the program. If they fail to do so, they will not be able to print returns.**

**Notes Outline**

**I. Introduction**

A. The introduction materials help the student understand the legal basis of income taxation, provides an overview of the types of returns and numbers, and an understanding of the dollar volume of income tax collections.

B. Students find the numbers in Table 1-1 and the material in the preceding paragraph to be interesting.

**II. LO 1 – Understand progressive, proportional, and regressive tax structures**

A. Students need to understand the notions of tax rate and tax base.

1. The base is the dollar amount upon which tax will be calculated.

2. The rate is the tax proportion to apply to the base.

B. Progressive rate structure.

1. Tax rate increases as the tax base increases.

2. U.S. individual income tax system is a progressive system.

3. Refer students to Table 1-2 or the Tax Rate Schedules in Appendix F.

4. Table 1-3 also illustrates the progressivity of the U.S. tax system.

C. Proportional rate structure.

1. Tax rate is the same regardless of the tax base.

2. Common example is state or local sales tax.

3. If we change to a flat tax system, we would be changing from a progressive rate structure to a proportional rate structure.

D. Regressive rate structure.

1. Tax rate decreases as the tax base increases.

2. Social security tax is a good example. Stops at $128,400 limit.

**III. LO 2 – Understand the concepts of average and marginal tax rates as well as a simple income tax formula.**

A. Marginal tax rate is the rate on the next dollar of income.

B. Average tax rate is the total tax liability divided by taxable income.

C. Mathematically, an average tax rate is a combination of a series of marginal rates.

D. The simple income tax formula that forms the basic structure of all returns is:

Income

− Permitted Deductions from Income

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= Taxable Income

× Appropriate Tax Rates

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= Tax Liability

− Tax Payments and Tax Credits

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= Tax Refund or Tax Due with Return

**IV. LO 3 – Understand the components of a basic 1040 income tax return**.

A. The Form 1040 is form all taxpayers will use to file their individual income tax returns.

B. There are six Schedules that can be included with Form 1040. As a tax return becomes more complex a taxpayer will use one or more or the Schedules.

C. Wages include salaries, tips, commissions, bonuses, severance pay, and other “compensation for services.”

1. Wages are reported to employees on Form W-2.

D. Interest is generally taxable. Interest is compensation for the use of money with respect to a bona fide debt.

E. Unemployment compensation is taxable because it is viewed as a substitute for taxable wages.

F. Taxpayers are permitted a standard deduction from income on line 8 of Form 1040.

1. The line 8 deduction is either $12,000 for single taxpayers or $24,000 for taxpayers filing married.

G. Taxable income is equal to the sum of the income items minus the deduction from income on line 8.

1. Taxable income is the tax base used to determine tax liability.

2. It is instructive at this point for students to clearly distinguish between total income and taxable income. This is a case where words have a very precise meaning – total income is very different from taxable income.

**V. LO 4 – Determine tax liability in instances when a 1040 return is appropriate.**

A. Tax liability is determined with reference to the Tax Tables printed in Appendix D and in the instructions to Form 1040 available on the IRS website.

B. Tax Tables only go up to taxable income of $100,000. For income over this limit, the Tax Rate Schedules must be used. These schedules are printed in Appendix F.

**In-class example.** Students find it helpful to have some in-class practice determining tax liability with reference to the Tax Tables. The instructor can choose various amounts of taxable income for either single or married taxpayers and have the students “go into” the Tax Tables to determine tax liability.

C. Point out the effect on tax liability of different filing statuses. Students can see the effect if they refer to the Tax Tables and read across a row.

D. The Tax Table liability is calculated using the mid-point of the taxable income range provided. Students can calculate precise tax liability using the Tax Rate Schedules in Appendix F and compare their results to the Tax Table numbers.

**In-class discussion point.** An instructor may wish to ask the question why the Tax Tables are necessary when everyone could use the tax rate schedules and get a precise number. One reasonable response is that the Tax Tables are easier to use and are not subject to as many errors.

E. Taxpayers may be subject to an additional “shared responsibility” tax related to provisions of the Affordable Care Act (ACA). If taxpayers do not have qualified health care insurance coverage and do not qualify for an exemption, a shared responsibility tax may be due. The tax is the greater of (a) 2.5% of household income that is greater than an income threshold or (b) a flat dollar amount of $695 per adult, $347.50 per child under 18 with a family maximum of $2,085. The tax is reported on Schedule 4, line 61. If the taxpayer had qualified health insurance coverage each month of the year, no additional tax is due.

**VI. LO 3 – Tax payments and determination of tax refund or amount owed**.

A. Most taxpayers pay some or all of their tax liability prior to the due date of the return. The vast majority of taxpayers do so using income tax withholding from their paycheck. Some taxpayers need to make quarterly estimated tax payments.

B. Taxpayers can take an Earned Income Tax Credit on their Form 1040. The EIC is discussed in Chapter 9 along with other credits.

C. The tax refund or tax due with the return is determined by comparing the tax liability on line 15 with the amount paid on line 18.

D. The refund or amount owed is the amount needed to “settle up” with the IRS.

**VII. LO 5 – Understand the types of tax authority and how they interrelate (Appendix A).**

*Note to Instructors*. If you want your students to be able to perform tax research, whether simple or complex, the material in the Appendix is an important starting point.

A. Taxes are complex. While there are some absolute answers, often “it depends” is the initial response to a tax question. To determine an answer, the tax practitioner often needs to refer to “tax authority” – the law, regulations, guidelines and precedent that form the basis of proper tax reporting. The Appendix exposes students to the various types of tax authority and their relative strengths.

B. There are three types of tax authority.

1. Statutory Sources

2. Administrative Sources

3. Judicial Sources

C. Statutory sources are the U.S. Constitution and tax laws passed by Congress. These tax laws comprise the Internal Revenue Code.

D. Administrative sources, in order of strength, are: IRS Regulations, Revenue Rulings, Revenue Procedures, Private Letter Rulings, and IRS Notices.

E. Judicial sources are the rulings from the courts. Figure 1-1 in the text illustrates applicable courts and appeal tracks.

**VIII. LO 6 – Understand the provisions of IRS Circular 230 for paid tax preparers (Appendix B).**

Students and instructors are encouraged to download Circular 230 from the IRS website.

A. All individuals who, for compensation, prepare a tax return, provide tax advice, or practice before the IRS are subject to the provisions of Circular 230. It is important to note that Circular 230 covers work and activities which are paid (compensated).

B. Failure to comply with Circular 230 will subject the individual to possible suspension or disbarment, public censure, fines, or civil or criminal prosecution.

C. Paid tax preparers must register with the IRS and obtain a preparer tax identification number (PTIN). The PTIN must be renewed annually.

D. Continuing professional education is required annually. Some professionals (CPA’s, attorneys) obtain their continuing education as part of their licensure process. Enrolled agents must obtain at least 72 hours per year and others must receive at least 15 hours annually. Ethics and professional conduct must be part of the continuing education.

E. Circular 230 sets forth numerous actions which paid preparers must, or must not, do. A summary of these actions is provided in the Appendix.