Individual Tax Computation

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Textbook: Taxation of Individual, 2017 Ed., Spilker

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Taxation of Individual and Business Entities, 2017th. Ed., Spilker which is the textbook assigned for the course CONT 4076 – "Aspectos Contributivos de Individuos" at the University of Puerto Rico, Río Piedras Campus.

Learning Objectives

1. Determine a taxpayer's <u>regular tax liability</u> and identify tax issues associated with the process.
2. Compute a taxpayer's <u>alternative minimum tax</u> liability and describe the tax characteristics of taxpayers most likely to owe the alternative minimum tax.
3. Calculate a taxpayer's <u>employment and self-employment taxes</u> payable and explain tax considerations relating to whether a taxpayer is considered to be an employee or a self-employed independent contractor.

Learning Objectives

4. Explain taxpayer filing and tax payment requirements and describe in general terms how to compute a taxpayer's underpayment, late filing, and late payment penalties.

Individual Tax Liability

Individual Income Tax

To determinate the individual tax liability, we must calculate the following taxes:

1. Regular Federal Income Tax
2. Alternative Minimum Tax
3. Employment and Self-Employment Taxes

Regular Federal Income Tax

Regular Federal Income Tax

2.1 Components of Regular Income Tax

Regular Federal Income Tax

2.1 Components of Regular Income Tax

1. **Basic Tax Computation**
   a. Filing status
   b. Progressive tax rates
2. **Exceptions**
   a. Preferential rates
   b. Investment income
   c. Kiddie tax

Regular Federal Income Tax

2.2 Basic Tax Computation

Regular Federal Income Tax

2.2 Basic Tax Computation

- As a general rule, individual taxpayers with taxable income must compute their income tax on ordinary income:
  1. Determining his/her filing status (ex. Single, married, etc.), and
  2. Using a tax table or tax schedules with progressive tax rates classified by filing status.

Regular Federal Income Tax

2.2 Basic Tax Computation

- **Ordinary Income**:
  - The ordinary income is taxed using the progressive tax rates.
  - Normally, the term ordinary income is used to identify the income earned by a taxpayer through personal effort (ex. Salary) or from a trade or business, among others.

Regular Federal Income Tax

2.3 <u>Progressive Tax Rates</u>

Regular Federal Income Tax

2.3 <u>Progressive Tax Rates</u>

- Tax brackets or marginal tax rates on ordinary income follows:
  - 10%
  - 15%
  - 25%
  - 28%
  - 33%
  - 35%
  - 39.6%

Regular Federal Income Tax

2.3 Progressive Tax Rates

- As an example, the following is the 2015 Tax Rate Schedule (Individual Taxpayer) where you can see the tax rate for each tax bracket:

If Taxable Income Is Between:	The Tax Due Is:
0 - $9,225	10% of taxable income
$9,226 - $37,450	$922.50 + 15% of the amount over $9,225
$37,451 - $90,750	$5,156.25 + 25% of the amount over $37,450
$90,751 - $189,300	$18,481.25 + 28% of the amount over $90,750
$189,301 - $411,500	$46,075.25 + 33% of the amount over $189,300
$411,501 - $413,200	$119,401.25 + 35% of the amount over $411,500
$413,201 +	$119,996.25 + 39.6% of the amount over $413,200

Regular Federal Income Tax

Example 1

- Jose is a single taxpayer. Assume that Jose's taxable income for 2015 is $7,000. Calculate the income tax.

Regular Federal Income Tax

Example 1

- Jose is a single taxpayer. Assume that Jose's taxable income for 2015 is $7,000. Calculate the income tax.

$7,000 x 10% = $700

Regular Federal Income Tax

Example 2

- Jose is a single taxpayer. Assume that Jose's taxable income for 2015 is $20,000. Calculate the income tax.

Regular Federal Income Tax

Example 2

- Jose is a single taxpayer. Assume that Jose's taxable income for 2015 is $20,000. Calculate the income tax.

1. **$20,000 - $9,226 = $10,774**
2. **$10,774 x 15% = $1,616**
3. **$1,616 + $922.50 = $2,538.50**

Regular Federal Income Tax

2.4 <u>Marriage penalty or benefit</u>

Regular Federal Income Tax

2.4 <u>Marriage penalty or benefit</u>

- A marriage penalty (benefit) occurs when, for a given level of income, a married couple has a greater (lesser) tax liability when they use the married filing jointly tax rate schedule to determine the tax on their joint income than they would have owed (in total) if each spouse would have used the single tax rate schedule to compute the tax on each spouse's individual income. See **Exhibit 1 on textbook.**

Taxes Calculated at Preferential Rates

Taxes Calculated at Preferential Rates

3.1 Preferential Rates

Taxes Calculated at Preferential Rates

3.1 Preferential Rates

- An individual will tax the **Capital Gains and Dividends** using a preferential rate according to his/her highest ordinary income tax rate in a taxable year.

Regular	Preferential
10%	0%
15%	0%
25%	15%
28%	15%
33%	15%
35%	15%
39.6%	20%

Taxes Calculated at Preferential Rates

3.2 Qualified Dividends

- **Definition**: A qualified dividend generally includes dividends distributed by a U.S. Corporation if the shareholder meets certain holding requirements for the stock (as described on chapter 7 on textbook).
- If the dividend meets the qualified dividend requirements, it is taxed at a **preferential rate** of 15% (20% for high income taxpayers, and 0% for low income taxpayers.
- If a dividend does not meet the qualified dividend requirement, it is taxed at **ordinary rates**.

Taxes Calculated at Preferential Rates

3.2 <u>Three-step Process to Determine their Tax Liability in Case a Taxpayer with Income Subject to Preferential Rate</u>

Taxes Calculated at Preferential Rates

3.2 <u>Three-step Process to Determine their Tax Liability in Case a Taxpayer with Income Subject to Preferential Rate</u>

1. <u>Split taxable income</u> into the portion that is subject to the preferential rate and the portion taxed at the ordinary rate.
2. <u>Compute the tax separately</u> on each type of income.
3. <u>Add the tax</u> on the income subject to the preferential tax rates and the tax on the income subject to the ordinary rate. This is the taxpayer’s regular tax liability.

Taxes Calculated at Preferential Rates

Example 3

Taxes Calculated at Preferential Rates

<u>**Example 3**</u>

Courtney is a single taxpayer. Assume that Courtney's taxable income for 2015 is $449,000 including $15,000 of qualifying dividends taxed at the preferential rate.

What would be Courtney's tax liability under these circumstances?

Taxes Calculated at Preferential Rates

Example 3

Step 1 – Split the Income

$449,000 (Taxable Income)

$434,000 (Ordinary) $15,000 (Dividend)

Taxes Calculated at Preferential Rates

Example 3

Step 2 – Compute the Tax

Ordinary (using the individual tax table)

1. $434,000 - $413,200 = **$20,800**
2. $20,800 x 39.6% = **$8,236.80**
3. $8,236.80 + $119,996.25 = **$128,233.05**

Taxes Calculated at Preferential Rates

Example 3

Step 2 – Compute the Tax

Preferential

1. If dividends were ordinary income, the dividends would have been taxed at 39.6% ($434,000 + $15,000 = $449,000)
2. Then, the qualified dividends will be tax at 20%.
3. **Preferential tax = $3,000** ($15,000 x 20%).

Taxes Calculated at Preferential Rates

Example 3

Step 3 – Add the Tax

Ordinary tax:	$128,233.05
Preferential tax:	3,000.00
Regular Income Tax:	$**131,233.05**

Net Investment Income Tax

Net Investment Income Tax

3.1 Computation of Tax

Net Investment Income

3.1 Computation of Tax

- A net investment income tax of 3.8% imposed on **lesser of**:
  1. **Net investment income** (Income less allowed deductions):
     a. Interest, dividends, annuities, royalties, rents.
     b. Passive activity income.
     c. Net gains from disposing of property.
  2. **Excess of modified AGI over**:
     a. $250,000 (MFJ)
     b. $125,000 (MFS)
     c. $200,000 (all others)

Net Investment Income

Example 4

Net Investment Income

Example 4

Courtney's AGI (and modified AGI) is $162,000, and her investment income consists of:

Taxable interest	$ 617
Dividend	700
Rental income	5,000

*How much net investment income tax will Courtney (**single**) owe?*

Net Investment Income

<u>Example 4</u>

Net Investment Income Tax of 3.8% imposed on **<u>lesser of</u>**:

1. Net investment income (Net): **$6,317**
   a. Interest, dividends, annuities, royalties, rents.
      $617 (interest) + $700 (dividends)
   b. Passive activity income.
      $5,000 rental income
   c. Net gains from disposing of property.

2. Excess of modified AGI over: **$ 0**
   a. $250,000 (MFJ)
   b. $125,000 (MFS)
   c. $200,000 (all others) [**$162,000 < $200,000**]

Net Investment Income

Example 4

The lesser of:

1. Net investment income: **$6,317**

2. Excess of modified AGI over: **$ 0**

is $0. Then, $0 x 3.8% = **$0 Net Investment Income Tax**

Net Investment Income

Example 5

Net Investment Income

Example 5

Courtney's AGI (and modified AGI) is $225,000, and her investment income consists of:

Taxable interest	$ 617
Dividend	700
Rental income	5,000

How much net investment income tax will Courtney (**single**) owe?

Net Investment Income

Example 5

Net Investment Income Tax of 3.8% imposed on lesser of:

- Net investment income (Net): **$ 6,317**
  - Interest, dividends, annuities, royalties, rents.
    - **$617 (interest) + $700 (dividends)**
  - Passive activity income.
    - **$5,000 rental income**
  - Net gains from disposing of property.

- Excess of modified AGI over: **$25,000**
  - $250,000 (MFJ)
  - $125,000 (MFS)
  - $200,000 (all others) [**$225,000 > $200,000**]

Net Investment Income

Example 5

The lesser of:

- Net investment income: **$6,317**
- Excess of modified AGI over: **$25,000**

is $6,317. Then, $6,317 x 3.8% = **$240 Net Investment Income Tax**

Kiddie Tax

Kiddie Tax

4.1 Rationale and General Rule

Kiddie Tax

4.1 <u>Rationale and General Rule</u>

- Parents can reduce their family's income tax bill by shifting income that would otherwise be taxed at their higher tax rates to their children whose income is taxed at lower rates.
  - <u>Earned income</u> cannot be shifted to other parties (assignment of income doctrine), but
  - <u>Unearned income</u>, however, ***can be shift to a child*** by transferring actual ownership of the income-producing property to the child.

Kiddie Tax

4.1 Rationale and General Rule

- Consequently, if the kiddie tax applies, children must pay tax on a certain amount of their unearned income at their parents' marginal tax rate rather than at their own marginal tax rate.

Kiddie Tax

4.2 Computation

Kiddie Tax

4.2 Computation

1. The Kiddie Tax applies when the child "net unearned income" is in excess of **$2,100**.
2. Net unearned income taxed applies if:
   a. Child is under age 18 at year end.
   b. Child is 18 at year end but earned income not greater than half of child's support.
   c. Child is over age 18 but under age 24, is a full-time student, and child's earned income not greater than half of child's support.

Kiddie Tax

4.2 <u>Computation</u>

3. The “net unearned income” is taxed at parents’ marginal rate.
4. Parents can elect to actually include this income on their tax return.

Kiddie Tax

Example 6

Kiddie Tax

Example 6

Suppose that during 2017, **Deron** (Courtney's son), 16 years old, received $1,100 in interest from an IBM bond, and he received another $2,200 in interest income from a money market account that his parents have been contributing to over the years.

*What is **Deron's** taxable income and corresponding tax liability?* (Deron's mother Courtney is subject to a 25% marginal tax rate.)

Kiddie Tax

Example 6

- Unearned income is $3,300 ($2,200 + $1,100).

Because Deron is younger than 18 years of age at the end of the year and his net unearned income exceeds $2,100, he is potentially subject to the kiddie tax.

Kiddie Tax

Example 6

Answer: $2,250 taxable income and $405 tax liability, calculated as follows:

Description	Amount	Explanation
(1) Gross income/AGI	$3,300	$1,100 interest from IBM bond + $2,200 interest All unearned income
(2) Standard deduction	1,050	Minimum for taxpayer claimed as a dependent on another return (no earned income, so must use minimum). See Chapter 6.
(3) Personal exemption	0	Claimed as a dependent on Courtney's return
(4) Taxable income	**$2,250**	(1) − (2) − (3)
(5) Gross unearned income minus $2,100	1,200	(1) − 2,100
(6) Net unearned income	$1,200	Lesser of (4) or (5)
(7) Courtney's ordinary marginal rate	25%	See Example 8-3 (use Courtney's rate because she is the custodial parent).
(8) Kiddie tax	$ 300	(6) × (7) (Deron's income taxed at Courtney's marginal rate.)
(9) Taxable income taxed at Deron's rate	1,050	(4) − (6)
(10) Tax on taxable income using Deron's tax rates	$ 105	(9) × 10% (See single filing status, $1,050 taxable income.)
Deron's total tax liability	**$ 405**	(8) + (10)

Alternative Minimum Tax

Alternative Minimum Tax

5.1 Rationale and General Rule

Alternative Minimum Tax

5.1 Rationale and General Rule

- The Alternative Minimum Tax (AMT) was implemented in 1986 to ensure that taxpayers generating income pay some minimum amount of income tax each year.
- The tax was originally targeted at higher-income taxpayers who were benefiting from or were perceived by the public to be benefiting from the excessive use (more than Congress intended) of tax preference items such as exclusions, deferrals, and deductions to reduce or even eliminate their tax liabilities.

Alternative Minimum Tax

5.1 Rationale and General Rule

- The Alternative Minimum Tax (AMT) is a tax on an alternative tax base meant to more closely reflect economic income than the regular income tax base.
- The AMT is more inclusive that is the regular income tax base.

Alternative Minimum Tax

5.2 Computation

Alternative Minimum Tax

5.2 <u>Computation</u>

1. Computes the <u>regular income tax liability</u> (Using the regular income tax base. Self-employment tax and 3.8% net investment tax are not considered regular tax).
2. Then, computes the <u>Alternative Minimum Tax (AMT)</u> (AMT base x applicable alternative tax rate).
3. Must pay the AMT only when the tax on the <u>AMT</u> base <u>exceeds</u> their <u>regular tax liability</u>.

Alternative Minimum Tax

Example 7

Alternative Minimum Tax

Example 7

- John's regular income tax liability of 2016 (using the regular income tax base) is **$5,000**. John's alternative minimum tax (AMT) for this taxable year is **$4,500**.
- John must pay the AMT only when the tax on the AMT base exceeds his regular tax liability. **Under this scenario, the income tax liability is $5,000** ($5,000 exceeds $4,500)**.**

Alternative Minimum Tax

Example 8

Alternative Minimum Tax

Example 8

- John's regular income tax liability of 2016 (using the regular income tax base) is **$5,000**. John's alternative minimum tax (AMT) for this taxable year is **$7,000**.
- John must pay the AMT only when the tax on the AMT base exceeds his regular tax liability. **Under this scenario, the income tax liability is $7,000** ($7,000 exceeds $5,000)**.**

Alternative Minimum Tax

EXHIBIT 8-2 Formula for Computing the Alternative Minimum Tax

	Regular Taxable Income
Plus:	Personal exemptions and standard deduction if taxpayer deducted the standard deduction in computing regular taxable income
Minus:	Phase-out of itemized deductions for regular tax purposes (if applicable)
Plus or Minus:	Other adjustments*
	Alternative minimum taxable income
Minus:	AMT exemption amount (if any)
Equals:	Tax base for AMT
Times:	AMT rate
Equals:	Tentative minimum tax
Minus:	Regular tax
Equals:	Alternative minimum tax

*Technically, some of these adjustments are referred to as preference items and some are referred to as adjustments. We refer to all of these items as adjustments for simplicity's sake.

Employment FICA Taxes

Employment FICA Taxes

6.1 General Rule

Employment FICA Taxes

6.1 General Rule

1. **Employer and Employee**: An employee must contribute 7.65% of his salary for Social Security and Medicare tax. The employer must contribute the same amount.

Employment FICA Taxes

6.1 General Rule

2. **Self-employed taxpayers**: A taxpayer with self-employment net income (ex. Sole-proprietorship) must contribute 15.3% for Social Security and Medicare.

Employment FICA Taxes

6.1 General Rule

3. **Limitations**: The FICA and Medicare tax is subject to limits and additional taxes as presented in the following table. (**See next page**)

Employment FICA Taxes

Description	Employee	Employer
Social Security Tax	**6.20%** (Limited to $118,500 in 2016)	**6.20%**
Medicare Tax (**Fully taxable**)	**1.45%** (Limited to: $200,000, $250,000 MFJ, $125,000 MFS) **AND** **2.35%** (in excess)	**1.45%**

Employment FICA Taxes

Description	Employee	Employer
Medicare Tax **(Fully taxable)**	**1.45%** (Limited to: $200,000, $250,000 MFJ, $125,000 MFS) **AND** **2.35%** (in excess)	**1.45%**

Employment FICA Taxes

6.1.1 Employee v. Self-employed

Employment FICA Taxes

6.1.1 Employee v. Self-employed

- Determining whether taxpayer is employee **or** independent contractor.
  - Primary question: who has control over how, when, where work is performed?

Employment FICA Taxes

6.1.1 Employee v. Self-employed

- To assist taxpayers in deciding whether the party receiving services has the requisite amount of control over the individual providing services, the IRS has published a list of 20 factors to consider (See next page). [**Rev. Rul. 87-41**]
- When these factors are absent, individuals are more likely to be classified as employees.

Employment FICA Taxes

6.1.1 Employee v. Self-employed

- A few of the factors suggesting independent contractor rather than employee status include the contractor's ability to:
  1. Set her own working hours.
  2. Work part-time.
  3. Work for more than one firm.
  4. Realized either a profit or a loss from the activity.
  5. Perform work somewhere other than on an employer's premises.
  6. Work without frequent oversight.

Employment FICA Taxes

6.2 <u>Self-employment tax</u>

Employment FICA Taxes

6.2 Self-employment tax

- Responsible for *entire* FICA tax (employee and employer share).
- Tax base is net earnings from self-employment (net Schedule C income (generally) and multiply by .9235)
- If net earnings from self-employment < $400, no Self Employment tax required.

Employment FICA Taxes

Example 9

Employment FICA Taxes

Example 9

- The taxpayer's net earnings from self-employment follows:

Revenues	$100,000
Operating expenses	40,000
Taxable Income (Schedule C)	$ 60,000
Multiply by	.9235
Net Earnings from Self Employment	$ 55,410

Employment FICA Taxes

Example 9:

$55,410 (Net Earnings)

Social Security	Medicare
$ 55,410	$ 55,410
x 12.4%	x 2.9%
$ 6,870.84 (Soc. Sec.)	**$1,606.89** (Medicare)

Self Employment Tax $8,477.73

Employment FICA Taxes

Example 10

Employment FICA Taxes

Example 10

- The taxpayer's net earnings from self-employment follows:

Revenues	$100,000
Operating expenses	99,500
Taxable Income (Schedule C)	$ 425
Multiply by	.9235
Net Earnings from Self Employment	$ 392

What is the Self Employment Tax?

Employment FICA Taxes

Example 10

- The taxpayer's net earnings from self-employment follows:

Revenues	$100,000
Operating expenses	99,500
Taxable Income (Schedule C)	$ 425
Multiply by	.9235
Net Earnings from Self Employment	$ 392

What is the Self Employment Tax? ***0, $392 < $400.***

Employment FICA Taxes

Example 11

Employment FICA Taxes

Example 11

- A **single** taxpayer's net earnings from self-employment follows:

Revenues	$ 500,000
Operating expenses	40,000
Taxable Income (Schedule C)	$ 460,000
▪ Multiply by	.9235
Net Earnings from Self Employment	$ 424,810

What is the Self Employment Tax?

Employment FICA Taxes

Example 11

- For this example, the self-employed taxpayer:
  1. is subject to $118,500 limit to Social Security portion, and
  2. apply the 0.9% additional Medicare tax.

Employment FICA Taxes

Example 11

$424,810 (Net Earnings)

$ 118,500	$ 424,810	$ 224,810*
x 12.4%	x 2.9%	x 0.9%
$ **14,694** (Soc. Sec.)	**$ 12,319** (Med.)	**$ 2,023** (Ad. Med.)

Self Employment Tax is $29,036

* $424,810 - $200,000 = $224,810

Employment FICA Taxes

6.3 Wages and Self-Employment Income

Employment FICA Taxes

6.3 Wages and Self-Employment Income

- How does $118,500 Social Security earnings limit apply when have both wages and SE earnings in the same year?
  - **Wages use up limit first. (See next example)**

Employment FICA Taxes

Example 12

Employment FICA Taxes

Example 12

Assume that Courtney received $100,000 of taxable compensation from EWD in 2015, and she received $180,000 in self-employment income from her weekend consulting activities.

Assume that Courtney's employer correctly withheld $6,200 of Social Security tax, $1,450 of Medicare tax, and $0 of .9 percent additional Medicare tax.

What amount of self-employment taxes is Courtney required to pay on her $180,000 of business income?

Employment FICA Taxes

Example 12

Description	Subject to Social Security	Subject to Medicare up to $200k	Subject to Additional Medicare
1. Salary $100,000	Withheld by employer	Withheld by employer	N/A
2. Self-employment income of $166,230 ($180,000 x .9235) limited to: • $18,500 ($118,500 - $100,000 salary) for social security, and • $166,230 for Medicare.	18,500	166,230	
3. Salary $100,000 + **self-employment income** $166,230 = $266,230 - $200,000.			$66,230
Total	$18,500	$166,230	$66,230

Employment FICA Taxes

Example 12

$424,810 (Net Earnings)

Soc. Sec.	Med.	Ad. Med.
$ 18,500	$166,230	$ 66,230
x 12.4%	x 2.9%	x 0.9%
$ **2,294** (Soc. Sec.)	**$ 4,820** (Med.)	**$ 596** (Ad. Med.)

Self Employment Tax is $7,710

Employment FICA Taxes

Answer: $7,710, computed as follows:

Description	Amount	Explanation
(1) Social Security wage base limit less employee compensation subject to Social Security tax	$ 18,500	$118,500 − $100,000, limited to $0
(2) Net earnings from self-employment	166,230	$180,000 × 92.35%
(3) Social Security portion of self-employment tax	2,294	[Lesser of Step (1) or (2)] × 12.4%
(4) Medicare tax	4,820	Step (2) × 2.9%
(5) Sum of taxpayer's compensation and net earnings from self-employment	266,230	$100,000 + Step (2)
(6) [Greater of (a) zero or (b) the amount from Step (5) minus $200,000] × 0.9%.	596	66,230 × 0.9%
(7) Step (6) less any .9 percent additional Medicare tax withheld by Courtney's employer.	596	596 − 0
(8) Steps (3) + (4) + (7)	7,710	2,294 + 4,820 + 596

Prepayment Requirements and Penalties

Prepayment Requirements and Penalties

7.1 Taxes must be *paid-as-you-go*

Prepayment Requirements and Penalties

7.1 <u>Taxes must be *paid-as-you-go*</u>

- The income tax must be paid on a *pay-as-you-go* basis.
- This means that the tax must be prepaid via **withholding** from salary or through periodic **estimated tax payments** during the tax year.
- <u>Employees</u> pay tax through withholding, and <u>self-employed taxpayers</u> generally pay taxes through estimated tax payments.

Prepayment Requirements and Penalties

7.1 Taxes must be *paid-as-you-go*

1. Withholdings

- The salary withholdings are treated as made equally throughout the year.

2. Estimated tax payments

- The estimated tax payments required to self-employed taxpayers are due on:
  - April $15^{th,}$
  - June 15^{th}
  - September 15^{th}
  - January 15^{th} of the following year.

Prepayment Requirements and Penalties

7.1 Taxes must be *paid-as-you-go*

- Estimated tax payments are required only if withholdings are insufficient to meet the taxpayer's tax liability.
- When taxpayers fall behind on their tax prepayments, they may be subject to an underpayment penalty.

Prepayment Requirements and Penalties

7.2 Underpayment Penalties

Prepayment Requirements and Penalties

7.2 Underpayment Penalties

1. **Penalty:**

- The underpayment penalty is determined using the following formula:

  Amount of underpayment at each quarter

  x federal short term rate + 3%

  Penalty

- Penalty is reported using Form 2210.

Prepayment Requirements and Penalties

7.2 Underpayment Penalties

2. **Safe-harbor Provisions:** There are two safe harbors determine on a quarterly basis the minimum tax prepayments that a taxpayer must have made to avoid the underpayment penalty.

Prepayment Requirements and Penalties

7.2 Underpayment Penalties

2. **Safe-harbor Provisions:**

   a. **The first safe harbor requires that a taxpayer must have paid at least the following percentage of the current-year liability via withholdings or estimated tax payment to avoid the underpayment penalty:**

Quarter	Percentage
April 15	22.5% (90%/4)
June 15	45% (22.5% x 2)
September 15	67.5% (22.5% x 3)
January 15 (next year)	90% (22.5% x 4)

Prepayment Requirements and Penalties

7.2 Underpayment Penalties

3. **Exception to Avoid Underpayment Penalty:** As a matter of administrative convenience, taxpayers who either:
   a. Had no tax liability in the previous year, or
   b. Whose tax payable after subtracting their withholding amounts (but no estimated payments) is less than $1,000

are not subject to underpayment penalties.

Prepayment Requirements and Penalties

Example 13

- Courtney's gross tax liability for the year 2016 including federal income tax, alternative minimum tax and self-employment taxes is $22,200.
- She had only $19,400 withheld from her paycheck by employer.
- The federal short-term rate is 5%.

1. **What is the underpayment amount per quarter?**
2. **What is the underpayment penalty?**

Prepayment Requirements and Penalties

Example 13

1. **What is the underpayment amount per quarter?**

- **The underpayment amount per quarter follows:**

Quarter	Actual Withholding	Required Withholding	Over (under) Withheld
Apr. 2016	$4,850 ($19,400 x 25%)	$4,995 ($22,200 x 90% x 25%)	($145)
Jun. 2016	$9,700 ($4,850 x 2)	$9,990 ($4,995 x 2)	($290)
Sep. 2016	$14,550 ($4,850 x 3)	$14,985 ($4,995 x 3)	($435)
Jan. 2017	$19,400 ($4,850 x 4)	$19,980 ($4,995 x 4)	($580)

Prepayment Requirements and Penalties

Example 13

2. **What is the underpayment penalty?**

- **The underpayment penalty per quarter follows:**

Quarter	Over (under) Withheld	Penalty Computation	Penalty
Apr. 2016	($145)	$145 x 8% x 25%	$3
Jun. 2016	($290)	$290 x 8% x 25%	$6
Sep. 2016	($435)	$435 x 8% x 25%	$9
Jan. 2017	($580)	$580 x 8% x 25%	$12
		TOTAL PENALTY	**$30**

- ***8% = 5% federal short-term rate + 3%***

Prepayment Requirements and Penalties

7.3 Late "Filing" Penalty

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7.3 Late "Filing" Penalty

1. **5%** of tax owed per month up to 25% if not fraudulent.

2. **15%** of tax owed per month up to 75% if fraudulent.

3. No penalty if no tax is due.

Prepayment Requirements and Penalties

7.4 <u>Late "Payment" Penalty</u>

Prepayment Requirements and Penalties

7.4 <u>Late "Payment" Penalty</u>

- If don't pay entire tax owed by due date of return
  a. **<u>0.5%</u>** of amount due per month up to 25% maximum if <u>not fraudulent.</u>
  b. **<u>15%</u>** of amount due per month up to 75% if <u>fraudulent.</u>

- Combined late filing and late payment penalties may not exceed maximum amounts for either one.

Prepayment Requirements and Penalties

Example 14

Prepayment Requirements and Penalties

Example 14

Assume Courtney filed her tax return on April 10 and attached a check of $2,830 made payable to the United States Treasury. The $2,830 consisted of her underpaid tax liability of $2,800 and her $30 underpayment penalty (computed on Example 11).

If Courtney had waited until May 1 to file her return and pay her taxes, what late filing and late payment penalties would she owe?

Prepayment Requirements and Penalties

<u>Example 14</u>

- <u>Late Filing Penalty</u>
  - $140 ($2,800 late payment x 5% x 1 month)
- <u>Late Payment Penalty</u>
  - $14 ($2,800 late payment × 0.5% × 1 month).

Combined late filing and late payment penalties may not exceed maximum amounts for either one. Note that the combined late filing and late payment penalty is limited to 5% per month. Consequently, **the "late filing penalty" and "late payment penalty" is $140**.