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How to Understand Common IRS Tax Terms

Article Highlights

- Filing status
- Adjusted gross income (AGI)
- Taxable income
- Marginal tax rate
- Alternative minimum tax (AMT)
- Tax Credits
- Underpayment of estimated tax penalty

When discussing taxes, reading tax related articles or instructions one needs to understand the lingo and acronyms used by tax professionals and authors to be able to grasp what they are saying. It can be difficult to understand tax strategies if you are not familiar with the basic terminologies used in taxation. The following provides you with the basic details associated with the most frequently encountered tax terms.

- **Filing Status -** Generally, if you are married at the end of the tax year, you have three possible filing status options: married filing jointly, married filing separately, or, if you qualify, head of household. If you were unmarried at the end of the year, you would file as single, unless you qualify for the more beneficial head of household status. A special status applies for some widows and widowers.

  Head of household is the most complicated filing status to qualify for and is frequently overlooked as well as incorrectly claimed. Generally, the taxpayer must be unmarried **AND**:

  o pay more than one half of the cost of maintaining his or her home, a household that was the principal place of abode for more than one half of the year of a qualifying child or certain dependent relatives, or
  o pay more than half the cost of maintaining a separate household that was the main home for a dependent parent for the entire year.

  A married taxpayer may be considered unmarried for the purpose of qualifying for head of household status if the spouses were separated for at least the last six months of the year, provided the taxpayer maintained a home for a dependent child for over half the year.

  Surviving spouse (also referred to as qualifying widow or widower) is a rarely used status for a taxpayer whose spouse died in one of the prior two years and who has a dependent child at home. Joint rates are used. In the year the spouse passed away, the surviving spouse may file jointly with the deceased spouse if not remarried by the end of the year. In rare circumstances, for the year of a spouse's death, the executor of the decedent's estate may determine that it is better to use the married separate status on the decedent's final return, which would then also require the surviving spouse to use the married separate status for that year.

- **Adjusted Gross Income (AGI) -** AGI is the acronym for adjusted gross income. AGI is generally the sum of a taxpayer's income less specific subtractions called adjustments (but before the standard or itemized deductions). The most common adjustments are penalties paid for early withdrawal from a savings account, and deductions for contributing to a traditional IRA or self-employment retirement plan. Many tax benefits and allowances, such as credits, certain adjustments, and some deductions are limited by a taxpayer's AGI.

- **Modified AGI (MAGI) -** Modified AGI is AGI (described above) adjusted (generally up) by tax-exempt and tax-excludable income. MAGI is a significant term when income thresholds apply to limit various deductions, adjustments, and credits. The definition of MAGI will vary depending on the item that is being limited.

- **Taxable Income -** Taxable income is AGI less deductions (either standard or itemized). Your taxable income is what your regular tax is based upon using a tax rate schedule specific to your filing status. The IRS publishes tax tables that are based on the tax rate schedules and that simplify the tax calculation, but the tables can only be used to look up the tax on taxable income up to $99,999.

- **Marginal Tax Rate (Tax Bracket) -** Not all of your income is taxed at the same rate. The amount equal to your standard or itemized deductions is not taxed at all. The next increment is taxed at 10%, then 12%, 22%, etc., until you reach the maximum tax rate, which is currently 37%. When you hear people discussing tax brackets, they are referring to the marginal tax rate. Knowing your marginal rate is important because any increase or decrease in your taxable income will affect your tax at the marginal rate. For example, suppose your marginal rate is 24% and you are able to reduce your income $1,000 by contributing to a deductible retirement plan. You would save $240 in federal tax ($1,000 x 24%). Your marginal tax bracket depends upon your filing status and taxable income. You can find your marginal tax rate using the table below.

  Keep in mind when using this table that the marginal rates are step functions and that the taxable incomes shown in the filing-status column are the top value for that marginal rate range.

2018 Marginal Tax Rates
Taxable Income by Filing Status

Marginal Tax Rate	Single	Head of Household	Joint*	Married Filed Separately
10%	9,525	13,600	19,050	9,525
12%	38,700	51,800	77,400	38,700
22%	82,500	82,500	165,000	82,500
24%	157,500	157,500	315,000	157,500
32%	200,000	200,000	400,000	200,000
35%	500,000	500,000	600,000	500,000
37%	Over 500,000	Over 500,000	Over 600,000	Over 500,000

* Also used by taxpayers filing as surviving spouse

  - **Taxpayer & Dependent Exemptions -** Prior to the changes made by tax reform you were allowed to claim a personal exemption for yourself, your spouse (if filing jointly), and each individual who qualifies as your dependent. The deductible exemption amount was adjusted for inflation annually; the amount for 2018 was supposed to be $4,150. However, the tax reform that became law in late 2017 didn't quite repeal the exemption deduction – it just suspended the deduction for exemptions for 2018 through 2025.

  - **Dependents -** To qualify as a dependent, an individual must be the taxpayer's qualified child or pass all five dependency qualifications: the (1) member of the household or relationship test, (2) gross income test, (3) joint return test, (4) citizenship or residency test, and (5) support test. The gross income test limits the amount a dependent can make if he or she is over 18 and does not qualify for an exception for certain full-time students. The support test generally requires that you pay over half of the dependent's support, although there are special rules for divorced parents and situations where several individuals together provide over half of the support.

- **Qualified Child -** A qualified child is one who meets the following tests:

  (1) Has the same principal place of abode as the taxpayer for more than half of the tax year

except for temporary absences;
(2) Is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual;
(3) Is younger than the taxpayer;
(4) Did not provide over half of his or her own support for the tax year;
(5) Is under age 19, or under age 24 in the case of a full-time student, or is permanently and totally disabled (at any age); and
(6) Was unmarried (or if married, either did not file a joint return or filed jointly only as a claim for refund).

- **Deductions -** A taxpayer generally can choose to itemize deductions or use the standard deduction. The standard deductions, which are adjusted for inflation annually, are illustrated below for 2018.

Filing Status	**Standard Deduction**
Single	$12,000
Head of Household	$18,000
Married Filing Jointly	$24,000
Married Filing Separately	$12,000

The standard deduction is increased by multiples of $1,600 for unmarried taxpayers who are over age 64 and/or blind. For married taxpayers, the additional amount is $1,300. The extra standard deduction amount is not allowed for elderly or blind dependents. Those with large deductible expenses can itemize their deductions in lieu of claiming the standard deduction. The standard deduction of a dependent filing his or her own return will oftentimes be less than the single amount shown above.

Itemized deductions generally include:

(1) Medical expenses, limited to those that exceed 7.5% of your AGI for 2018. The reduction percentage will increase to 10% after 2018.
(2) Taxes consisting primarily of real property taxes, state income (or sales) tax, and personal property taxes, but limited to a total of $10,000 for the year.
(3) Interest on qualified home acquisition debt and investments; the latter is limited to net investment income (i.e., the deductible interest cannot exceed your investment income after deducting investment expenses).
(4) Charitable contributions, generally limited to 60% of your AGI, but in certain circumstances the limit can be as little as 20% or 30% of AGI.
(5) Gambling losses to the extent of gambling income, and certain other rarely encountered deductions.

- **Alternative Minimum Tax (AMT) -** The Alternative Minimum Tax is another way of being taxed that has often taken taxpayers by surprise, even though prior to the 2017 tax reform legislation an ever-increasing number of taxpayers were being hit with AMT. The Alternative Minimum Tax (AMT) is a tax that was originally intended to ensure that wealthier taxpayers with large write-offs and tax-sheltered investments pay at least a minimum tax. However, even taxpayers whose only "tax shelter" is having a large number of dependents or paying high state income or property taxes were being affected by the AMT. Your tax must be computed by the regular method and also by the alternative method. The tax that is higher must be paid. The following are some of the more frequently encountered factors and differences that contribute to making the AMT greater than the regular tax.

o The standard deduction is not allowed for the AMT, and a person subject to the AMT cannot itemize for AMT purposes unless he or she also itemizes for regular tax purposes. Therefore, it is important to make every effort to itemize if subject to the AMT.

o Itemized deductions:

- Medical deductions for regular tax purposes are allowed in excess of 7.5% of the taxpayer's AGI and 10% of AGI for AMT in 2018. After that they both will be 10%. Taxes are not allowed at all for the AMT.
- Interest in the form of home equity debt interest and interest on debt for non-conventional homes such as motor homes and boats are not allowed as AMT deductions. For years 2018–2025, interest paid on home equity debt is also not allowed for regular tax purposes.

o Nontaxable interest from private activity bonds is tax free for regular tax purposes, but some is taxable for the AMT.
o Statutory stock options (incentive stock options) when exercised produce no income for regular tax purposes. However, the bargain element (difference between grant price and exercise price) is income for AMT purposes in the year the option is exercised.
o Depletion allowance in excess of a taxpayer's basis in the property is not allowed for AMT purposes.

A certain amount of income is exempt from the AMT, but the AMT exemptions are phased out for higher-income taxpayers.

AMT EXEMPTIONS & PHASE OUT - 2018

Filing Status	Exemption Amount	Income Where Exemption is Totally Phased Out
Married Filing Jointly	$109,400	$1 Million
Married Filing Separate	$54,700	$500,000
Unmarried	$70,300	$500,000

(1) $95,550 for married taxpayers filing separately

Your tax will be whichever is the higher of the tax computed the regular way and by the Alternative Minimum Tax. Anticipating when the AMT will affect you is difficult, because it is usually the result of a combination of circumstances. In addition to those items listed above, watch out for transactions involving limited partnerships, depreciation, and business tax credits only allowed against the regular tax. All of these can strongly impact your bottom-line tax and raise a question of possible AMT. Fortunately, due to tax reform that the increased AMT exemption amounts and set higher thresholds before the exemption is phased out, fewer taxpayers are expected to be paying AMT after 2017. Tax Tip: If you were subject to the AMT in the prior year, you itemized your deductions on your federal return for the prior year, and had a state tax refund for that year, part or all of your state income tax refund from that year may not be taxable in the regular tax computation. To the extent that you received no tax benefit from the state tax deduction because of the AMT, that portion of the refund is not included in the subsequent year's income.

- **Tax Credits -** Once your tax is computed, tax credits can reduce the tax further. Credits reduce your tax dollar for dollar and are divided into two categories: those that are nonrefundable and can only offset the tax, and those that are refundable. In addition, some credits are not deductible against the AMT, and some credits, when not fully used in a specific tax year, can carry over to succeeding years. Although most credits are a result of some action taken by the taxpayer, there are some commonly encountered credits that are based simply on the number or type of your dependents or your income. These and another popular credit are outlined below.

o **Child Tax Credit -** Thanks to tax reform the child tax credit has been increased to $2,000 per child (up from $1,000 in 2017). If the credit is not entirely used to offset tax, the excess portion of the credit, up to the amount that the taxpayer's earned income exceeds a threshold ($2,500 for 2018), but not more than $1,400, is refundable. The credit begins to phase out at incomes (MAGI) of

$400,000 for married joint filers and $200,000 for other filing status. The credit is reduced by $50 for each $1,000 (or fraction of $1,000) of modified AGI over the threshold.

o **Dependent Credit** – A new, nonrefundable credit will be available to taxpayers with a dependent who isn't a qualifying child starting with 2018 returns, and like the increased child tax credit is designed to offset the loss of the exemption deduction as a result of tax reform. The dependent credit is $500. A qualifying child, the taxpayer, and if married, the spouse are not eligible for this credit. A child who isn't a qualifying child but who qualifies as a dependent under the dependent relative rules would qualify the taxpayer to claim this credit.

o **Earned Income Credit** - This is a refundable credit for a low-income taxpayer with income from working either as an employee or a self-employed individual. The credit is based on earned income, the taxpayer's AGI, and the number of qualifying children. A taxpayer who has investment income such as interest and dividends in excess of $3,500 (for 2018) is ineligible for this credit. The credit was established as an incentive for individuals to obtain employment. It increases with the amount of earned income until the maximum credit is achieved and then begins to phase out at higher incomes. The table below illustrates the phase-out ranges for the various combinations of filing status and earned income and the maximum credit available.

2018 EIC PHASE-OUT RANGE

Number of Children	Joint Return	Others	Maximum Credit
None	$14,170 – $20,950	$8,490 – $15,270	$519
1	$24,350 – $46,010	$18,660 – $40,320	$3,461
2	$24,350 – $51,492	$18,660 – $45,802	$5,716
3	$24,350 – $54,884	$18,660 – $49,194	$6,431

o **Residential Energy-Efficient Property Credit** - This credit is generally for energy-producing systems that harness solar, wind, or geothermal energy, including solar-electric, solar water-heating, fuel-cell, small wind-energy, and geothermal heat-pump systems. These items qualify for a 30% credit with no annual credit limit. Unused residential energy-efficient property credit is generally carried over through 2021.The credit rate reduces to 26% in 2020 and 22% in 2021. The credit expires after 2021.

- **Withholding and Estimated Taxes** - Our "pay-as-you-go" tax system requires that you make payments of your tax liability evenly throughout the year. If you don't, it's possible that you could owe an underpayment penalty. Some taxpayers meet the "pay-as-you-go" requirements by making quarterly estimated payments. However, when your income is primarily from wages, you usually meet the requirements through wage withholding and rely on your employer's payroll department to take out the right amount of tax, based on the withholding allowances shown on the Form W-4 that you filed with your employer. To avoid potential underpayment penalties, you are required to deposit by payroll withholding or estimated tax payments an amount equal to the lesser of:

1) 90% of the current year's tax liability; or
2) 100% of the prior year's tax liability or, if your AGI exceeds $150,000 ($75,000 for taxpayers filing as married separate), 110% of the prior year's tax liability.

If you had a significant change in income during the year, we can assist you in projecting your tax liability to maximize the tax benefit and delay paying as much tax as possible before the filing due date.

Please call if this office can be of assistance with your tax planning needs.