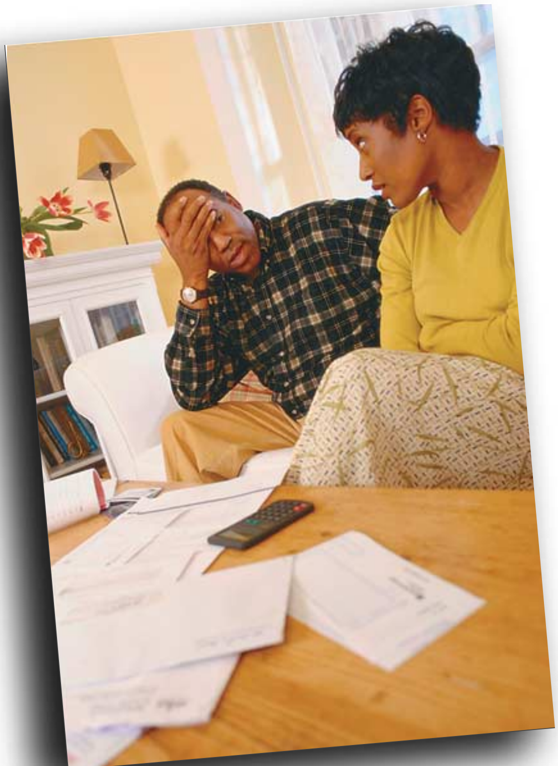
CHAPTER

Using Tax Concepts for Planning

4



Faced with $22,000 in unreimbursed medical expenses, the Covingtons pledged themselves to paying the debt off as soon as possible. With a combined income of $150,000 per year they managed to pay $2,000 per month over an 11-month period. An example of financial responsibility? Yes. A success story? No. What did they do wrong?

Unfortunately for the Covingtons, they paid the debt off over a period of time that fell into two calendar years. They paid $10,000 in the first calendar year and $12,000 in the second calendar year, unaware that medical expenses representing the first 7.5 percent of adjusted gross income in a tax year is not included in itemized deductions. Since 7.5 percent of $150,000 is $11,250, the Covingtons were unable to claim a dime of the medical expenses paid the first year. In the second year they were able to claim a mere $750. Had they paid the entire $22,000 in one tax year they would have been able to claim an itemized deduction of $10,750. Since their marginal tax rate is 30 percent, they could have reduced their taxes by 30 percent of $10,750 or a total tax savings of $3,225.

Now you might ask, "Yes, but could they afford to pay off the entire medical bill in the first year?" The Covingtons did possess sufficient assets to pay off the medical expenses in one calendar year. By the time their accountant became aware of the situation, it was too late. The moral of this story is that you as a taxpayer may be able to take advantage of significant tax breaks. However, while an accountant can help you to complete your taxes correctly and pay the least amount possible, it is your *responsibility to time actions during the tax year to put yourself in position to take full advantage of any tax-reduction strategies.*

This chapter explains the most fundamental basics of individual taxation. Taxes are among the largest expenditures in your budget. The more you earn, the higher your taxes are. Nearly every facet of a financial plan involves some knowledge of taxes. The tax laws can help you conserve your income, enhance your investments, or protect the transfer of your wealth at your death. It is no overstatement to say that knowledge about individual income taxes is crucial to sound financial planning.

The objectives of this chapter are to:

- explain how to determine your tax filing status,
- explain how to calculate your gross income,
- demonstrate how deductions and exemptions can be used,
- explain how to determine your taxable income, tax liability, and refund or additional taxes owed, and
- demonstrate how to fill out a tax form and determine your tax liability.

BACKGROUND ON TAXES

Financial planning involves spending and investment decisions that affect your income. Some examples include your decision to:

- take a second job so that you can enhance your wealth,
- purchase a home that will be financed with a mortgage,
- invest in stocks or bonds, and
- contribute a portion of your salary to your retirement account.

All of these decisions affect the amount of taxes you pay and therefore affect your wealth. Individuals pay taxes at the federal, state, and local levels. The purpose of taxes is to finance government activities. On average, Americans earn enough by May 10 of any year to pay their federal, state, and local taxes. The federal tax system is administered by a branch of the U.S. Treasury Department called the Internal Revenue Service (IRS). In 2001, major changes in the federal tax laws included significant reductions in tax rates scheduled to be phased in by 2010. In 2003, new legislation advanced many of the tax reductions. This chapter covers the federal income tax planning process and significant tax laws. (Later chapters will also refer to the tax implications of specific planning decisions.)

FICA (Federal Insurance Contributions Act) taxes
Taxes paid to fund the Social Security System and Medicare.

SOCIAL SECURITY AND MEDICARE TAXES

Your wages are subject to FICA (Federal Insurance Contributions Act) taxes that fund the Social Security System and Medicare. Your employer withholds FICA

4.1 Financial Planning Online: Internal Revenue Service

Go to:
http://www.irs.gov

This Web site provides:
information about tax rates, guidelines, and deadlines.

taxes from your wages in each paycheck. The Social Security System uses the funds to make payments to you upon retirement (subject to age and other requirements). Medicare is a government health insurance program that covers people over age 65 and provides payments to health care providers in the case of illness. The Social Security taxes are equal to 6.20 percent of your salary up to a maximum level (the level was $87,900 in the year 2004 and changes over time). There is no Social Security tax on income beyond this maximum level. The Medicare taxes are 1.45 percent of your salary, regardless of the salary amount. Your employer pays the same amount of FICA and Medicare taxes on your behalf.

Medicare
A government health insurance program that covers people over age 65 and provides payments to health care providers in the case of illness.

EXAMPLE

Stephanie Spratt earned a salary of $38,000 this year. She is subject to total FICA taxes of 7.65 percent which is based on 6.20 percent for Social Security and 1.45 percent for Medicare. Thus, her Social Security taxes and Medicare taxes are:

	Social Security Tax	**Medicare Tax**
Tax rate	6.2% (up to a maximum of $87,900)	1.45%
Tax amount	.062 × $38,000 = $2,356	.0145 × $38,000 = $551

Her total FICA taxes are $2,907 (computed as $2,356 + $551).

The taxes described above also apply if you are self-employed. However, self-employed persons serve not only as the employee but also as the employer. Their FICA taxes are equal to 15.3 percent, which represents the 7.65 percent FICA tax paid by the employee plus the 7.65 percent FICA tax paid by the employer. The Social Security tax rate is again capped at the maximum limit, while the Medicare tax rate applies to the entire earnings. One-half of the FICA taxes paid by self-employed people is tax-deductible (i.e., half can be deducted from income when determining the federal income tax).

Personal Income Taxes

personal income taxes
Taxes imposed on income earned.

Your income is also subject to personal income taxes, which are taxes imposed on income you earn. Any year that you earn income, you must file a completed Form 1040, which determines whether a sufficient amount of taxes was already withheld from your paycheck, whether you still owe some taxes, or whether the government owes you a refund. If you still owe some taxes, you should include a check for the taxes owed along with your completed Form 1040.

Form 1040EZ, the simplest tax form to use, is an appropriate alternative to Form 1040 in some cases. Generally, this form is used by individuals whose filing status is either single or married filing jointly, who have no dependents, and whose taxable income is less than $100,000. The deadline for filing with the IRS is April 15 following the tax year, plus any extensions. Tax forms can be downloaded from several Web sites, including Yahoo! Several software programs, including TurboTax, MacInTax, and Quicken, are also available to help you prepare your return. An example of Form 1040 is shown in Exhibit 4.1. Refer to this form as you read through the chapter.

Tax Relief Acts

In the summer of 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (more commonly referred to as the Tax Relief Act of 2001). Provisions of the $1.35 trillion tax cut package began taking effect in 2001 and were scheduled to be phased in gradually until the law expires in 2011. Designed to provide a short-term stimulus to the economy and long-term tax relief for individual taxpayers, the Act reduced inequalities in the current tax code, simplified several sections of the tax code, and provided educational incentives to a broad range of taxpayers. Tax relief for parents includes an increase in the child tax credit and an expansion of the dependent care credit. The 2001 tax reform measures also expanded contribution limits to retirement plans.

On May 6, 2003, Congress passed the Jobs and Growth Tax Releif Reconciliation Act of 2003. The Act accelerated much of the tax relief scheduled to occur as a result of the 2001 Tax Relief Act. Specifically, individual tax rates were lowered by 2-3%, the child tax credit was increased to $1000 per child for 2003 and 2004, the standard deduction for married taxpayers was increased to twice the standard deduction for single taxpayers, the 15% tax

Exhibit 4.1 Form 1040

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2004 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.)
LABEL HERE
Use the IRS label. Otherwise, please print or type.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 16.	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		

Presidential Election Campaign (See page 16.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Filing Status
Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions
6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
			☐
			☐
			☐
			☐

If more than four dependents, see page 18.
d Total number of exemptions claimed

Boxes checked on 6a and 6b
No. of children on 6c who:
• **lived with you**
• **did not live with you due to divorce or separation (see page 18)**
Dependents on 6c not entered above
Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7 Wages, salaries, tips, etc. Attach Form(s) W-2 — 7
8a **Taxable** interest. Attach Schedule B if required — 8a
b **Tax-exempt** interest. **Do not** include on line 8a — 8b
9a Ordinary dividends. Attach Schedule B if required — 9a
b Qualified dividends (see page 20) — 9b
10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20) — 10
11 Alimony received — 11
12 Business income or (loss). Attach Schedule C or C-EZ — 12
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐ — 13
14 Other gains or (losses). Attach Form 4797 — 14
15a IRA distributions 15a — b Taxable amount (see page 22) — 15b
16a Pensions and annuities 16a — b Taxable amount (see page 22) — 16b
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E — 17
18 Farm income or (loss). Attach Schedule F — 18
19 Unemployment compensation — 19
20a Social security benefits 20a — b Taxable amount (see page 24) — 20b
21 Other income. List type and amount (see page 24) — 21
22 Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶ — 22

Adjusted Gross Income

23 Educator expenses (see page 26) — 23
24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ — 24
25 IRA deduction (see page 26) — 25
26 Student loan interest deduction (see page 28) — 26
27 Tuition and fees deduction (see page 29) — 27
28 Health savings account deduction. Attach Form 8889 — 28
29 Moving expenses. Attach Form 3903 — 29
30 One-half of self-employment tax. Attach Schedule SE — 30
31 Self-employed health insurance deduction (see page 30) — 31
32 Self-employed SEP, SIMPLE, and qualified plans — 32
33 Penalty on early withdrawal of savings — 33
34a Alimony paid b Recipient's SSN ▶ — 34a
35 Add lines 23 through 34a — 35
36 Subtract line 35 from line 22. This is your **adjusted gross income** ▶ — 36

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2004)

Exhibit 4.1 *(continued)*

Form 1040 (2004) Page **2**

Tax and Credits

Standard Deduction for—
- People who checked any box on line 38a or 38b **or** who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $4,850

Married filing jointly or Qualifying widow(er), $9,700

Head of household, $7,150

37	Amount from line 36 (adjusted gross income)	37
38a	Check if: ☐ **You** were born before January 2, 1940, ☐ Blind. ☐ **Spouse** was born before January 2, 1940, ☐ Blind. **Total boxes checked ▶ 38a** ☐	
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 38b ☐	
39	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	39
40	Subtract line 39 from line 37	40
41	If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet on page 33	41
42	**Taxable income.** Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-	42
43	**Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972	43
44	**Alternative minimum tax** (see page 35). Attach Form 6251	44
45	Add lines 43 and 44 ▶	45
46	Foreign tax credit. Attach Form 1116 if required — 46	
47	Credit for child and dependent care expenses. Attach Form 2441 — 47	
48	Credit for the elderly or the disabled. Attach Schedule R — 48	
49	Education credits. Attach Form 8863 — 49	
50	Retirement savings contributions credit. Attach Form 8880 — 50	
51	Child tax credit (see page 37) — 51	
52	Adoption credit. Attach Form 8839 — 52	
53	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 — 53	
54	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ______ — 54	
55	Add lines 46 through 54. These are your **total credits**	55
56	Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- ▶	56

Other Taxes

57	Self-employment tax. Attach Schedule SE	57
58	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	58
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59
60	Advance earned income credit payments from Form(s) W-2	60
61	Household employment taxes. Attach Schedule H	61
62	Add lines 56 through 61. This is your **total tax** ▶	62

Payments

If you have a qualifying child, attach Schedule EIC.

63	Federal income tax withheld from Forms W-2 and 1099 — 63	
64	2004 estimated tax payments and amount applied from 2003 return — 64	
65a	**Earned income credit (EIC)** — 65a	
b	Nontaxable combat pay election ▶ 65b	
66	Excess social security and tier 1 RRTA tax withheld (see page 54) — 66	
67	Additional child tax credit. Attach Form 8812 — 67	
68	Amount paid with request for extension to file (see page 54) — 68	
69	Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885 — 69	
70	Add lines 63, 64, 65a, and 66 through 69. These are your **total payments** ▶	70

Refund

Direct deposit? See page 54 and fill in 72b, 72c, and 72d.

71	If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you **overpaid**	71
72a	Amount of line 71 you want **refunded to you** ▶	72a
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings	
▶ d	Account number	
73	Amount of line 71 you want **applied to your 2005 estimated tax** ▶ 73	

Amount You Owe

74	**Amount you owe.** Subtract line 70 from line 62. For details on how to pay, see page 55 ▶	74
75	Estimated tax penalty (see page 55) — 75	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no.	( )

Form **1040** (2004)

bracket for married taxpayers was increased to twice that of single taxpayers, and investors were rewarded with lower long-term capital gains and dividend tax rates.

These laws do not change the process used for computing taxes; instead, they impact various adjustments made to determine your personal income taxes. As the process to determine your personal taxes is described in this chapter, pertinent new tax provisions are identified. (Changes that affect retirement and estate planning are discussed in Chapters 19 and 20.)

Notice from Exhibit 4.1 that determining taxes requires you to address filing status, gross income, adjusted gross income, exemptions, itemized deductions, standard deduction, taxable income (adjusted gross icome), tax credits, and capital gains and lossses.

Each of these topics is covered in this chapter so that you will be equipped to fill out Form 1040 to determine your taxes. As the tax concepts are explained, a continuing example is provided for Stephanie Spratt, who has a relatively simple tax situation. Near the end of the chapter, a more complex example is provided showing taxes for a family.

FILING STATUS

Each year, taxpayers must specify a filing status when submitting their income tax return. The alternatives are:

- single,
- married filing joint return,
- married filing separate return,
- head of household, and
- qualifying widow(er) with dependent child.

Married people can combine their incomes and file a joint return, or each can file a separate tax return. The "head of household" status can be selected by single people who have at least one dependent in their household. The tax rates applied when using this status may be more favorable than when filing under the "single" status. If you are a qualifying widow(er) with a dependent child, you are entitled to use the joint tax rates for two years following the death of your spouse, assuming that you do not remarry, have a child for whom you can claim an exemption, and pay more than half the cost of maintaining your residence.

GROSS INCOME

gross income
All reportable income from any source, including salary, interest income, dividend income, and capital gains received during the tax year.

To calculate your federal income tax, first determine your gross income. Gross income consists of all reportable income from any source. It includes your salary, interest income, dividend income, and capital gains received during the tax year. It also includes income from your own business, as well as from tips, prizes and awards, rental property, and scholarships that exceed tuition fees and book costs. Some types of income are not taxed, including health and casualty insurance reimbursements, child support payments received, reimbursements of moving expenses and other expenses by an employer, veteran's benefits, and welfare benefits.

Wages and Salaries

If you work full-time, your main source of gross income is probably your salary. Wages and salaries, along with any bonuses, are subject to federal income taxes. Contributions made to an employer retirement plan are often made with pre-tax dollars and thus reduce your gross income. Consequently, they are not subject to immediate taxation. Contributions to your employer-sponsored retirement account, whether made by you or your employer, are not subject to income taxes until those funds are withdrawn from the account. Many employees take advantage of their employer-sponsored retirement plan to reduce their current income taxes and obtain tax-deferred growth of their retirement fund.

Interest Income

interest income
Interest earned from investments in various types of savings accounts at financial institutions, from investments in debt securities such as Treasury bonds, or from providing loans to other individuals.

Individuals can earn interest income from investments in various types of savings accounts at financial institutions. They can also earn interest income from investing in debt securities such as Treasury bonds that pay interest periodically or from providing loans to other individuals. Note that interest income earned from investments in municipal bonds issued by state and local government agencies is normally exempt from federal taxation. Any tax-exempt interest income is not included when determining taxes.

Dividend Income

dividend income
Income received in the form of dividends paid on shares of stock or mutual funds.

Individual taxpayers can earn dividend income by investing in stocks or mutual funds. Some firms pay dividends to their shareholders on a quarterly basis. Other firms elect not to pay dividends to their shareholders and instead reinvest all of their earnings to finance their existing operations. This can benefit shareholders because a firm's share price is more likely to appreciate over time if the firm reinvests all of its earnings.

The worksheet for adding up your interest income and dividend income—Schedule B of Form 1040—is shown in Exhibit 4.2.

Capital Gains

Individuals can purchase securities (also called financial assets) such as stocks or debt instruments (such as bonds) that are issued by firms to raise capital.

Exhibit 4.2 Schedule B of Form 1040

Schedules A&B (Form 1040) 2004 OMB No. 1545-0074 Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. | **Your social security number**

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See page B-2 and the instructions for Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer ▶	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040, line 9a ▶	6	

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See page B-2.)

	You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; or **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.	Yes	No
7a	At any time during 2004, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ▶		
8	During 2004, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See page B-2		

For Paperwork Reduction Act Notice, see Form 1040 instructions. **Schedule B (Form 1040) 2004**

capital gain
Income earned when an asset is sold at a higher price than was paid for the asset.

capital loss
A loss that results from selling an asset at a lower price than was paid for the asset.

short-term capital gain
A gain on assets that were held less than 12 months.

long-term capital gain
A gain on assets that were held for 12 months or longer.

They also invest in other income-producing assets, such as rental properties. When you sell these types of assets at a higher price than you paid, you earn a capital gain. If you sell the assets for a lower price than you paid, you sustain a capital loss.

A short-term capital gain is a gain on assets that were held less than 12 months. A long-term capital gain is a gain on assets that were held for 12 months or longer. The capital gains tax (the tax that is paid on capital gains) on a short-term capital gain is based on your marginal tax rate, as if it was additional income. The capital gains tax on a long-term capital gain is restricted to a 15-percent maximum, and is usually lower than the tax on short-term gains. Net short-term gains and long-term gains are reported in the section on gross income.

The capital gains tax is a maximum of 15 percent of the long-term capital gain and is even lower for individuals in very low ordinary income tax brackets. For example, an individual in the 15 percent tax bracket will pay a 5 percent capital gains tax. The tax benefits are larger for individuals in the higher tax brackets. An individual in the 35 percent tax bracket will pay only a 15 percent tax on long-term capital gains.

EXAMPLE

Suppose your current income is high. You are subject to a 28 percent marginal tax rate, so you must pay a tax of 28 percent on any additional income that you earn. Stock that you purchased 11 months ago has increased in value by $20,000. If you sell the stock today, your capital gain will be classified as "short term," and you will pay a tax rate of 28 percent on that gain, or $5,600. If you hold the stock for another month, your capital gain will be classified as "long term," therefore subjecting it to a 15 percent maximum tax rate. If the value of the stock is the same in a month, your tax on the long-term gain will be $3,000. Thus, holding the stock for one more month cuts your taxes by $2,600.

capital gains tax
The tax that is paid on a gain earned as a result of selling an asset for more than the purchase price.

Use the worksheet labeled Schedule D of Form 1040 for individuals to determine your capital gains taxes. This worksheet is shown in Exhibit 4.3.

Determining Gross Income

Gross income is determined by adding up your salary, interest income, dividend income, and capital gains.

EXAMPLE

Stephanie Spratt earned a salary of $38,000 over the most recent year. She earned no income from interest, dividends, or short-term capital gains. Her gross income over the year is:

Salary	$38,000
+Interest Income	0
+Dividend Income	0
+Capital Gain	0
=Gross Income	$38,000

Exhibit 4.3 Schedule D of Form 1040

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
2004
Attachment Sequence No. 12

Name(s) shown on Form 1040 | Your social security number

Part I **Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					

2	Enter your short-term totals, if any, from Schedule D-1, line 2 . . .	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d) . . .	3	
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . .	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions . . .	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) . . .	7	

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					

9	Enter your long-term totals, if any, from Schedule D-1, line 9 . . .	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d) . . .	10	
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . .	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . .	12	
13	Capital gain distributions. See page D-1 of the instructions . . .	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions . . .	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . .	15	

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2004**

Exhibit 4.3 *(continued)*

Schedule D (Form 1040) 2004 Page **2**

Part III **Summary**

16	Combine lines 7 and 15 and enter the result. If line 16 is a loss, skip lines 17 through 20, and go to line 21. If a gain, enter the gain on Form 1040, line 13, and then go to line 17 below . .	**16**	
17	Are lines 15 and 16 **both** gains? ☐ **Yes.** Go to line 18. ☐ **No.** Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-7 of the instructions . . . ▶	**18**	
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-8 of the instructions . . . ▶	**19**	
20	Are lines 18 and 19 **both** zero or blank? ☐ **Yes.** Complete Form 1040 through line 42, and then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 34 of the Instructions for Form 1040. **Do not** complete lines 21 and 22 below. ☐ **No.** Complete Form 1040 through line 42, and then complete the **Schedule D Tax Worksheet** on page D-9 of the instructions. **Do not** complete lines 21 and 22 below.		
21	If line 16 is a loss, enter here and on Form 1040, line 13, the **smaller** of: • The loss on line 16 or • ($3,000), or if married filing separately, ($1,500) } . . . **Note.** When figuring which amount is smaller, treat both amounts as positive numbers.	**21**	( )
22	Do you have qualified dividends on Form 1040, line 9b? ☐ **Yes.** Complete Form 1040 through line 42, and then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 34 of the Instructions for Form 1040. ☐ **No.** Complete the rest of Form 1040.		

Schedule D (Form 1040) 2004

Adjusted Gross Income

adjusted gross income
Adjusts gross income for contributions to IRAs, alimony payments, interest paid on student loans, and other special circumstances.

Your adjusted gross income is calculated by adjusting your gross income for contributions to individual retirement accounts (IRAs), alimony payments, interest paid on student loans, and other special circumstances. If you do not have any special adjustments, your adjusted gross income is the same as your gross income.

EXAMPLE

Stephanie Spratt did not contribute any of her salary to an IRA this year. She also does not qualify for any other special adjustments to her gross income. Therefore, her adjusted gross income is $38,000, the same as her gross income.

DEDUCTIONS AND EXEMPTIONS

You may be able to claim deductions and exemptions, which reduce the amount of your gross income subject to taxation.

Standard Deduction

standard deduction
A fixed amount that can be deducted from adjusted gross income to determine taxable income.

marriage penalty
Term used to describe the fact that many two-income married people pay more in taxes than if they were single.

The standard deduction is a fixed amount deducted from adjusted gross income to determine taxable income. The amount of the standard deduction is not affected by the amount of income you earned during the year; instead it varies according to your filing status and whether you are over age 65. Each year, the IRS adjusts the amount of the standard deduction to keep pace with inflation. The Tax Relief Act of 2003 addressed the so-called marriage penalty in the tax code that causes many two-income married people to pay more in taxes than if they were single. Starting in 2004, the standard deduction for married couples was increased to twice the income level for single individuals. Exhibit 4.4 lists the standard deduction amounts for the 2004 tax year. The additional deductions in the last column of Exhibit 4.4 are applied to each qualifying spouse (taxpayer), regardless of whether that person files a joint or separate return, and to blind taxpayers.

EXAMPLE

Stephanie Spratt's tax filing status is single. Therefore, she can take a standard deduction of $4,850 from her adjusted gross income. Alternatively, she can itemize her deductions (as explained next). She will take the standard deduction unless her itemized deductions exceed the standard deduction.

Exhibit 4.4 Standard Deduction Amounts for the 2004 Tax Year

Status	Under Age 65	Over Age 65 or Blind
Married, filing jointly	$9,700	$950
Head of household	7,150	1,200
Single	4,850	1,200
Married, filing separately	4,850	950

Itemized Deductions

itemized deductions Specific expenses that can be deducted to reduce taxable income.

Itemized deductions are specific expenses that can be deducted to reduce taxable income. Taxpayers itemize their deductions on the tax form so that they can subtract these deductions from their adjusted gross income to determine their taxable income.

You should work through the process of itemizing your deductions and then compare the total dollar value to the standard deduction that you are allowed. The larger the amount of deductions, the lower will be the taxable income on which taxes are assessed. Thus, a taxpayer will choose to itemize if doing so results in lower taxable income than the standard deduction. Otherwise, the taxpayer will use the standard deduction. We examine several of the more common itemized deductions below.

interest expense Interest paid on borrowed money.

Interest Expense. When people borrow funds to purchase a home, they pay interest expense, or interest on the money that they borrowed. The annual interest payments made on such a loan are an itemized deduction. Interest payments on student loans are an itemized deduction subject to income limits. The Tax Relief Act of 2001 increased the income ranges, making the deduction more widely available. Interest payments made on car loans or personal loans, annual credit card fees, and loan fees are not tax-deductible.

state income tax An income tax imposed by some states on people who receive income from employers in that state.

State Taxes. Many states impose a state income tax (between 3 and 10 percent) on people who receive income from employers in that state. These state taxes can be deducted as an itemized deduction.

real estate tax A tax imposed on a home or other real estate in the county where the property is located.

Real Estate Taxes. Owners of homes or other real estate are subject to real estate taxes imposed by the county where the property is located. These real estate taxes can be deducted as an itemized deduction.

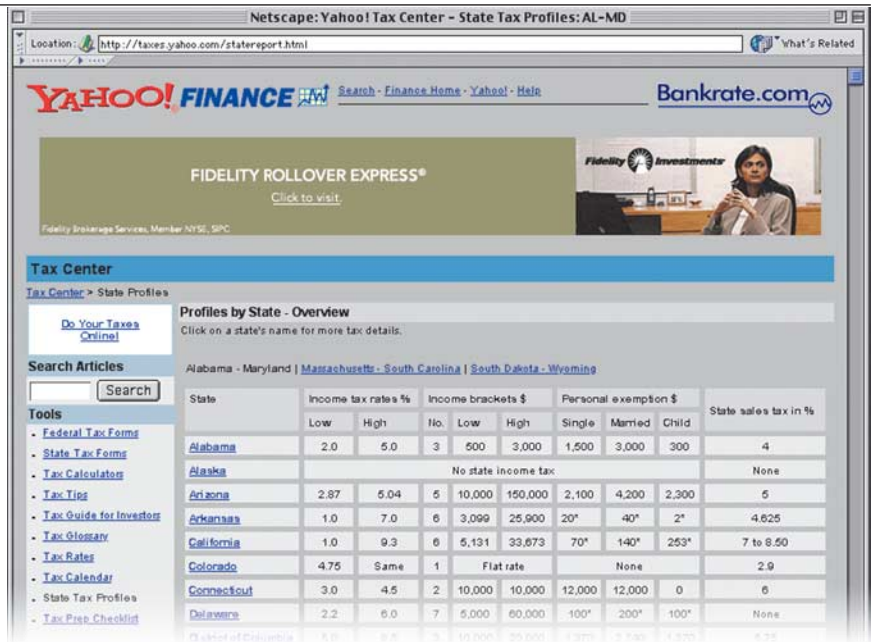
Medical Expenses. People who incur a large amount of unreimbursed medical expenses may deduct the following expenses:

1. Amounts paid for prevention, diagnosis, or alleviation of physical or mental defects or illness.

4.2 Financial Planning Online: State Income Tax Rates

Go to:
http://taxes.yahoo.com/statereport.html

This Web site provides:
income tax rates and information on personal exemptions for each state.



2. Amounts paid to affect any structure or function of the body.

3. Expenses for transportation primarily for and essential to medical care.

4. Accident and health insurance premiums (such as for health care and prescription drugs).

People with medical expenses that exceed 7.5 percent of adjusted gross income may deduct that excess amount as an itemized deduction. This deduction is specifically for people who incur an unusually high level of medical expenses in a particular year.

Charitable Gifts. People who make charitable gifts to qualified organizations (such as the Humane Society) can deduct their contribution as an itemized deduction.

Other Expenses. It may be possible to deduct a portion of losses due to casualties or theft and major job-related expenses that are not reimbursed by employers. However, these expenses are deductible only if they are substantial, as they must be in excess of specified minimum levels (based on a percentage of adjusted gross income). Note that qualified higher education expenses (other than room and board) may also be deducted.

Summary of Deductible Expenses. Taxpayers sum up all of their various deductions to determine whether to itemize or use the standard deduction.

EXAMPLE

Stephanie Spratt does not own a home; therefore, she pays no interest expense on a mortgage and pays no real estate taxes. She does not pay state income taxes in her state of Texas. She made charitable contributions amounting to $200. Her total eligible itemized deductions are:

Deductions	
Interest Expense	$0
State Income Taxes	0
Real Estate Taxes	0
Unreimbursed Medical	0
Charity	200
Total	$200

If Stephanie decides to take the standard deduction, she can deduct $4,850 from her gross income instead of the itemized deductions described above. Since the standard deduction far exceeds her itemized deductions of $200, she decides to take the standard deduction.

The worksheet for itemized deductions is Schedule A of Form 1040 for individuals. An example of Schedule A is shown in Exhibit 4.5.

Exemptions

exemption
An amount that can be deducted for each person who is supported by the income reported on a tax return.

An exemption is permitted for each person who is supported by the income reported on a tax return. For example, children in a household are claimed as exemptions by their parents on tax forms. Exemptions reduce taxable income even if the taxpayer decides to take the standard deduction rather than itemizing. A personal exemption can be claimed for the person filing a tax return, for a spouse, and for each dependent. Each year the amount of the exemption is adjusted for inflation. In the 2004 calendar year, each personal exemption was $3,100. The total amount of exemptions is deducted from gross income to determine taxable income.

EXAMPLE

Stephanie Spratt is single and has no children living in her household. She can claim one exemption for herself, which allows her to deduct $3,100 from her adjusted gross income.

Exhibit 4.5 Schedule A of Form 1040

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

2004

Attachment Sequence No. **07**

Name(s) shown on Form 1040 | **Your social security number**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-2)	1	
	2	Enter amount from Form 1040, line 37 [2]		
	3	Multiply line 2 by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid (See page A-2.)	5	State and local **(check only one box)**: a ☐ Income taxes, **or** b ☐ General sales taxes (see page A-2)	5	
	6	Real estate taxes (see page A-3)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8		9
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶	11	
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-4 for special rules	12	
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13	
	14	Add lines 10 through 13		14
Gifts to Charity	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15	
If you made a gift and got a benefit for it, see page A-4.	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16	
	17	Carryover from prior year	17	
	18	Add lines 15 through 17		18
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)		19
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶	20	
	21	Tax preparation fees	21	
(See page A-5.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22	
	23	Add lines 20 through 22	23	
	24	Enter amount from Form 1040, line 37 [24]		
	25	Multiply line 24 by 2% (.02)	25	
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-		26
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶		27
Total Itemized Deductions	28	Is Form 1040, line 37, over $142,700 (over $71,350 if married filing separately)? ☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 39. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶		28

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2004**

TAXABLE INCOME AND TAXES

Before calculating the taxes that you owe, you need to determine your taxable income, as explained next.

taxable income
Adjusted gross income less deductions and exemptions.

Taxable Income

Taxable income is equal to adjusted gross income less deductions and exemptions.

EXAMPLE

Recall that Stephanie Spratt's adjusted gross income is $38,000, her standard deduction is $4,850, and her exemptions are $3,100. Therefore, her taxable income for the year is:

Adjusted Gross Income	$38,000
− Deductions	4,850
− Exemptions	3,100
= Taxable Income	$30,050

Taxes

Once you know what your taxable income is, you can use a table such as Exhibit 4.6 to determine the taxes that you owe. Taxes are dependent not only on your taxable income, but also on your filing status. Exhibit 4.6 shows the tax schedules for different filing statuses for the 2004 tax year. Notice that the income tax system in the United States is progressive. That is, the higher an individual's income, the higher the percentage of that income paid in taxes.

progressive
A term used to characterize a tax system where a positive relationship exists between an individual's income level and that person's tax rate.

The Tax Relief Act of 2001 created a new 10 percent bracket that applied to the first $6,000 of income for single taxpayers and $12,000 of income for married couples filing jointly in 2001. The income ranges were increased in 2004 as a result of the Tax Relief Act of 2003. In addition, the income tax rates above 15 percent were reduced in 2003 so that the 27% tax rate dropped to 25%, the 30% tax rate fell to 28%, the 35% tax rate fell to 33%, and the 38.6% tax rate was reduced to 35%. Furthermore, as mentioned earlier, the income level subject to the 15 percent tax rate for the married filing jointly category will be increased to address the marriage penalty.

Determining Your Tax Liability. To determine your tax liability, simply refer to your filing status and follow the instructions at the top of the columns of the tax schedule. Converting the instructions into formula form gives the following equation for the tax liability:

$$\textit{Tax Liability} = \textit{Tax on Base} + [\textit{Percentage on Excess over the Base} \times (\textit{Taxable Income} - \textit{Base})]$$

Exhibit 4.6 Individual Tax Rates for the Year 2004

If Your Taxable Income Is	You Pay This Amount on the Base of the Bracket	Plus This Percentage on the Excess over the Base
Panel A. Single Individuals		
Up to $7,150	$0	10.0%
$7,150–$29,050	$715.00	15.0%
$29,050–$70,350	$4,000.00	25.0%
$70,350–$146,750	$14,325.00	28.0%
$146,750–$319,100	$35,717.00	33.0%
Over $319,100	$92,592.00	35.0%
Panel B. Married Couples Filing Jointly or Qualifying Widow(er)		
Up to $14,300	$0	10.0%
$14,300–$58,100	$1,430.00	15.0%
$58,100–$117,250	$8,000.00	25.0%
$117,250–$178,650	$22,787.50	28.0%
$178,650–$319,100	$39,979.50	33.0%
Over $319,100	$86,328.00	35.0%
Panel C. Married Couples Filing Separately		
Up to $7,150	$0	10.0%
$7,150–$29,050	$715.00	15.0%
$29,050–$58,625	$4,000.00	25.0%
$58,625–$89,325	$11,393.75	28.0%
$89,325–$159,550	$19,989.75	33.0%
Over $159,550	$43,164.00	35.0%
Panel D. Head of Household		
Up to $10,200	$0	10.0%
$10,200–$38,900	$1,020.00	15.0%
$38,900–$100,500	$5,325.00	25.0%
$100,500–$162,700	$20,725.00	28.0%
$162,700–$319,100	$38,141.00	33.0%
Over $319,100	$89,753.00	35.0%

for those with one qualifying child, and less than $34,458 for those with more than one qualifying child. The credit reduces the amount of taxes owed, if any.

Other Tax Credits. Other tax credits may also be available. For example, there are tax credits for child care and adoptions. The tax credit amount is dependent on the expenses incurred and income limits.

COMPREHENSIVE TAX EXAMPLE

To reinforce your understanding of the tax concepts discussed in this chapter we will now examine a complex tax example. Ken Hein's compensation from his employer was $44,000 in 2004. He also had $1,500 of interest income and $2,500 of dividend income this year. He contributed $4,000 toward his employer-sponsored retirement account. Ken incurred various deductible expenses that will be mentioned shortly. He also had a short-term capital gain of $2,000 and a long-term capital gain of $1,000 this year.

Ken's contribution to his employer-sponsored retirement plan does not count as salary for federal income tax purposes. However, he will still pay FICA taxes on that amount. Ken's FICA taxes, personal income taxes, and capital gain taxes are determined here.

Ken's FICA Taxes

The FICA taxes on Ken Hein's $44,000 salary are as follows:

	Social Security Tax	**Medicare Tax**
Tax rate	6.2% (up to a salary of $87,900)	1.45%
Tax amount	.062 × $44,000 = $2,728	.0145 × $44,000 = $638

Thus, Ken's total FICA taxes are $2,728 + $638 = $3,366.

Ken's Personal Taxes

Ken's personal taxes are determined by computing his gross income, his adjusted gross income, his deductions, and his exemptions.

Gross Income. Ken's gross income is:

Salary (after retirement contribution)	$40,000
+ Interest Income	1,500
+ Dividend Income	2,500
+ Long-Term Capital Gain	1,000
+ Short-Term Capital Gain	2,000
= Gross Income	$47,000

certain income levels. A key provision of the child tax credit is that it is available as a refund to low-income workers who owe no income tax.

college expense credits
Tax credits for parents who incur college expenses, based on the amount of financial support they provide.

College Expense Credits. Some college expense credits are also allowed. Parents receive a tax credit equal to $1,000 for the first $1,000 that they provide to each dependent for college expenses in each of the first two years of college. They also receive a 50 percent tax credit on the next $1,000 spent on college (or up to $500) for each child in each of the first two years of college. If you pay $1,800 in the first or second year of college, you receive a tax credit of $1,400 (computed as a $1,000 credit for the first $1,000 paid and a 50 percent credit on the additional $800 paid). Self-supporting students can use the tax credits to reduce their own taxes. There are limits (increased by the Tax Relief Act of 2001) imposed on the amount of expense credits allowed. Furthermore, the tax credit for college expenses is reduced or eliminated for taxpayers with high income levels.

As a result of the Tax Relief Act of 2001, education savings accounts (previously called Education IRAs) allow tax-free contributions of $2,000 (the previous limit was $500 per year). State and private universities can also offer prepaid tuition programs with tax benefits.

Section 529 College Savings Plan. In 2001, the tax laws were changed to allow substantial tax benefits for parents who wish to set aside money for their children's future college expenses. When parents invest funds in the Section 529 college savings plan, any income or gains from the investment will not be taxed as long as the funds are ultimately used to pay for college expenses. Some states impose a state tax when funds are withdrawn and used to pay college expenses.

All parents are eligible for the 529 plan, regardless of their income amount. They can contribute up to $200,000 or more in the account, depending on the state's requirements. If the parents decide not to use the funds to pay for the designated child's college expenses, they can withdraw the funds but are subject to significant penalties.

There are expenses associated with college savings plans. Advisers who help parents establish an account and investment firms that manage the accounts charge fees. Each state has its own specific investment manager and investment options. Parents can request that the money be invested in a specific stock portfolio managed by the designated investment firm for that state. The performance of the money contributed by the parents will match the growth of the stock portfolio value. If the stock portfolio value declines over time, the value of the contributions will decline as well.

earned income credit
A special credit for taxpayers who earn low incomes; can reduce the amount of taxes owed.

Earned Income Credit. The earned income credit is a special credit for taxpayers who earn low incomes. To qualify, you must work, have earned income, and have investment income of less than $2,650. Adjusted gross income in 2004 must be less than $11,490 for taxpayers without a qualifying child, less than $30,338 certain income levels. A key provision of the child tax credit is that it is available as a refund to low-income workers who owe no income tax.

college expense credits
Tax credits for parents who incur college expenses, based on the amount of financial support they provide.

College Expense Credits. Some college expense credits are also allowed. Parents receive a tax credit equal to $1,000 for the first $1,000 that they provide to each dependent for college expenses in each of the first two years of college. They also receive a 50 percent tax credit on the next $1,000 spent on college (or up to $500) for each child in each of the first two years of college. If you pay $1,800 in the first or second year of college, you receive a tax credit of $1,400 (computed as a $1,000 credit for the first $1,000 paid and a 50 percent credit on the additional $800 paid). Self-supporting students can use the tax credits to reduce their own taxes. There are limits (increased by the Tax Relief Act of 2001) imposed on the amount of expense credits allowed. Furthermore, the tax credit for college expenses is reduced or eliminated for taxpayers with high income levels.

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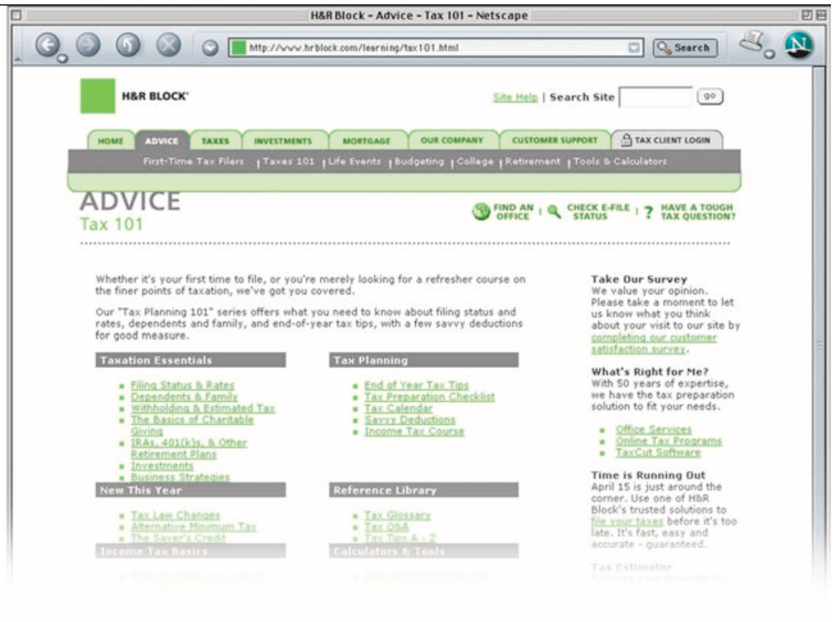
earned income credit
A special credit for taxpayers who earn low incomes; can reduce the amount of taxes owed.

Earned Income Credit. The earned income credit is a special credit for taxpayers who earn low incomes. To qualify, you must work, have earned income, and have investment income of less than $2,650. Adjusted gross income in 2004 must be less than $11,490 for taxpayers without a qualifying child, less than $30,338

4.3 Financial Planning Online: Tax Information Resource

Go to:

This Web site provides:
Useful information on taxation essentials, tax planning, tax basics, calculators, and tools.



Adjusted Gross Income. Ken does not have any special adjustments, so his adjusted gross income is the same as his gross income ($47,000).

Standard Deduction. Ken Hein is married and files his tax return jointly; he is under age 65. Per Exhibit 4.4, his standard deduction is $9,700, which he can deduct from his adjusted gross income to determine his taxable income. Alternatively, he can itemize deductions instead of using the standard deduction. He will choose the option that minimizes his tax liability.

Itemized Deductions. Ken's itemized deductions for this year include $7,000 of mortgage interest, $2,000 in state income taxes, and $3,000 of real estate taxes. In addition, Ken incurred medical expenses of $8,450. Since his adjusted gross income is $47,000, the first $3,525 (computed as .075 × $47,000) of his medical expenses are not deductible. Since his medical expenses exceed 7.5 percent of his adjusted gross income by $4,925, he can deduct $4,925 of medical expenses as an itemized deduction.

Medical Expenses	$8,450	
Amount That Is Not Deductible	− 3,525	(computed as .075 × $47,000)
Amount That Is Deductible	$4,925	

Ken contributed $1,000 to a local animal shelter. Therefore, he can deduct $1,000 as an itemized deduction.

Total Deductions. Ken Hein's deductions from his adjusted gross income are summarized here:

Deductions	
Interest Expense	$7,000
State Income Taxes	2,000
Real Estate Taxes	3,000
Medical	4,925
Charity	1,000
Total	$17,925

Ken Hein can deduct $17,925 as a result of his itemized deductions, versus only $9,700 if he uses the standard deduction. Thus, he is better off itemizing than taking the standard deduction.

Exemptions. Ken Hein has a wife and an 18-year-old daughter that he supports in his household. He can claim his personal exemption and one exemption each for his wife and daughter. Thus, the total amount of exemptions he can claim for the 2002 tax year is:

Personal Exemption	$3,100
Exemptions for Wife and One Dependent (2 × $3,000)	$6,200
Total	$9,300

Taxable Income. Recall that Ken Hein's adjusted gross income is $47,000, his itemized deductions amount to $17,925, and his exemptions amount to $9,000. Thus, Ken Hein's taxable income is determined as:

Adjusted Gross Income		$47,000
Deductions	$17,925	
Exemptions	9,300	
Total	$27,225	
Taxable Income		$19,775

Therefore, Ken's taxable income is $19,775. This includes a $1,000 long-term capital gain, which will be discussed in the next section. The following calculations apply to the taxable income, excluding the long-term capital gain, or $19,775 − $1,000 = $18,775. Ken's filing status is "married, filing jointly." Thus, his applicable tax rates are in Panel B of Exhibit 4.6.

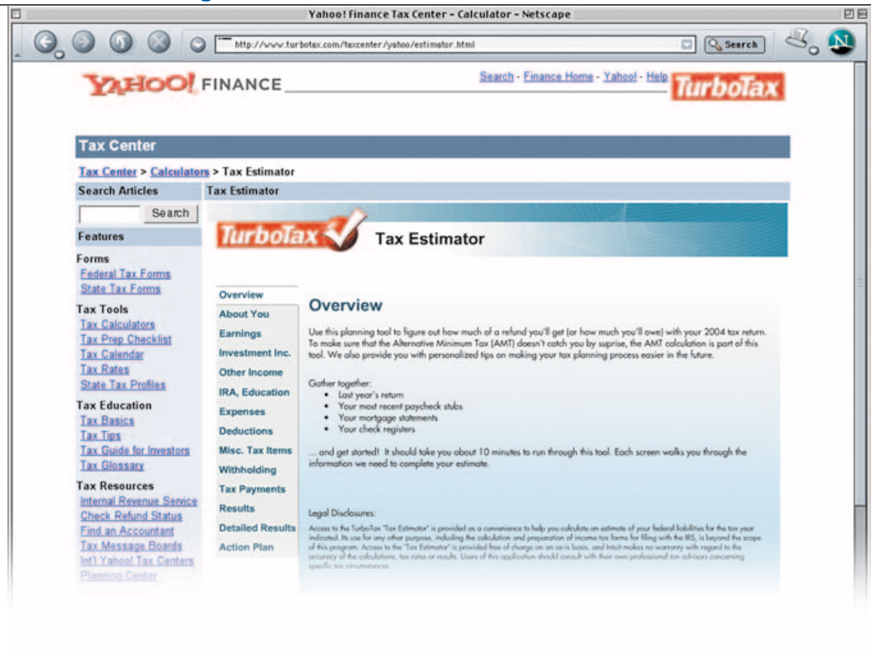
Ken uses the following steps to determine his taxes:

- His income falls within the second bracket in Panel B, from $14,300 to $58,100.

4.4 Financial Planning Online: Estimating Your Taxes

Go to:

This Web site provides: an estimate of your tax liability for the year and the tax refund that you will receive (if you already paid in more taxes than your tax liability), based on your income, filing status, exemptions, and deductions.



- The base of that bracket is $14,300.
- The tax rate applied to the excess income over the base is 15 percent, as shown in the third column of Panel B.
- Ken's excess income over the base is $\$18{,}775 - \$14{,}300 = \$4{,}475$. Thus, the tax on the excess over the base is 15 percent of $4,475, or $671.25.

In summary, his tax liability prior to adding his capital gain tax is:

$$
\begin{aligned}
\text{Tax Liability} &= \text{Tax on Base} + [\text{Percentage on Excess over the Base} \times \\
&\quad (\text{Taxable Income} - \text{Base})] \\
&= \$1{,}430 + [15\% \times (\$18{,}775 - \$14{,}300)] \\
&= \$1{,}430 + [15\% \times (\$4{,}475)] \\
&= \$1{,}430 + \$671.25 \\
&= \$2{,}101.25.
\end{aligned}
$$

Ken's Capital Gain Tax

Recall that Ken had a long-term capital gain of $1,000. Reviewing Exhibit 4.3, based on his taxable income of $19,775, he is subject to a long-term capital gain tax rate of 5 percent (note that the tax rate can be as high as 15 percent for some individuals). Ken's long-term capital gain tax is:

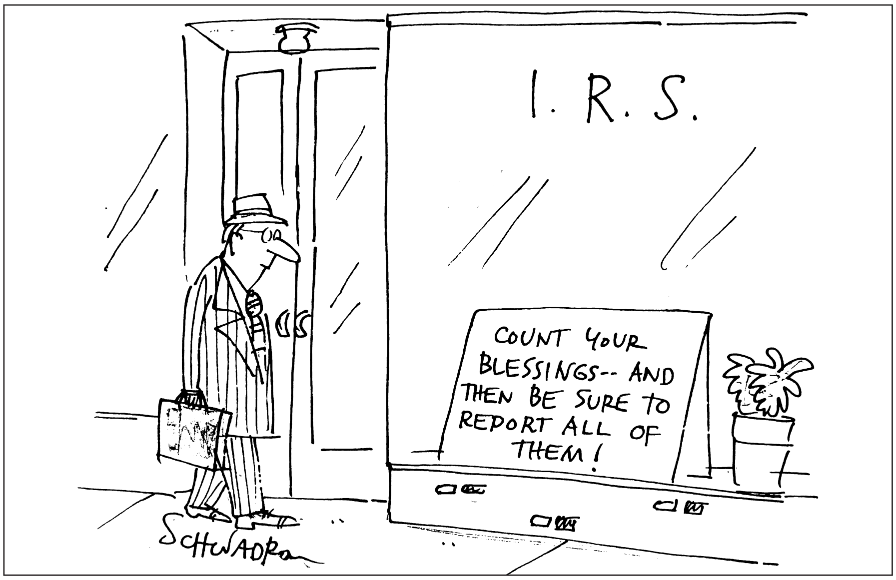
$$\text{Capital Gain Tax} = \text{Long-Term Capital Gain} \times \text{Long-Term Capital Gain Tax Rate}$$
$$= \$1{,}000 \times .05$$
$$= \$50$$

Ken's total tax liability is therefore $2,151.25 ($2,101.25 as computed on the $18,775 + $50 on the long-term capital gain).

FOCUS ON ETHICS: REDUCING YOUR TAXES

Do you know anyone who likes to pay taxes? Odds are you don't. Most people dislike paying taxes and put much effort into reducing their tax liability. It can be tempting to report a lower salary than you earned when filing your tax return. Or self-employed individuals may consider reporting a lower level of income than they actually earned. The IRS monitors tax returns to detect underestimated returns, so there is a strong likelihood that the IRS will uncover any fraudulent behavior. And there are large fines for illegally reducing taxes.

Fortunately, there are many legal ways to reduce your taxes. Organize records for things like your charitable donations and medical expenses in a tax-planning folder so you will not overlook a potential deduction. Prepare your return early in the year, so that you won't make a careless mistake in the rush to meet the April 15 deadline. Make sure that you have included all the tax exemptions and deductions that you qualify for on your return and that you haven't made any miscalculations. You may even seek advice from an accountant to ensure that you did not overlook any deductible expense.



HOW TAX PLANNING FITS WITHIN YOUR FINANCIAL PLAN

The key tax planning decisions for building your financial plan are:

1. What tax savings are currently available to you?
2. How can you increase your tax savings in the future?

The key tax concepts for building your financial plan are recognizing different deductions and exemptions as you plan your future. These deductions and exemptions will enable you to reduce your taxes and therefore increase your net cash flows. An example of how the tax concepts apply to Stephanie Spratt's financial plan is provided in Exhibit 4.7.

Since individuals who earn a high level of income can be exposed to very high tax rates, they should consider ways to reduce their tax liability. Some of the most useful strategies to reduce taxes are having a mortgage (because interest payments are tax-deductible), investing in retirement accounts that offer tax advantages, investing in stocks that pay no dividends, and investing in municipal bonds whose interest is exempt from federal taxes. These strategies are discussed in more detail later in the text.

Exhibit 4.7 Application of Tax Concepts to Stephanie Spratt's Financial Plan

Goals for Tax Planning

1. *Reduce taxable income (thereby reducing taxes paid) to the extent allowable by the IRS.*
2. *Reduce taxes paid by deferring income.*

Analysis

Present Situation:

Annual Salary = *$38,000*

Federal Income Taxes = *$4,250.00*

Taxes (excluding FICA) as a Percentage of Salary = *11.18%*

Reduce Taxes by:	**Comment**
Increasing deductions?	*The only qualified deduction I had was for a charitable contribution of $200, so this is not an option for me this year.*
Reducing gross income?	*I did not contribute any portion of my income to an individual retirement account or a qualified retirement plan; therefore, this option is not available.*
Total tax savings?	*$0 per year*

Long-Term Tax Plan:

Reduce Taxes by:	Comment
Increasing deductions?	*If I purchase a home, the interest expense on my mortgage loan, as well as the real estate taxes I will pay, both qualify as itemized deductions. These deductions will likely be higher than the standard deduction to which I would be entitled. I can therefore reduce my taxable income and taxes paid.*
Reducing gross income?	*I can also consider a contribution to an IRA or to my employer's qualified pension plan. If I can afford to contribute $3,000 of my salary to either the IRA or the qualified plan, I will reduce my gross income and defer taxes paid on that portion of my income.*
Tax savings (computed below)	*$722.50*

To compute my estimated tax savings, I will compare the taxes paid under my current situation to what I would pay if I bought a home and paid $6,000 in interest and real estate taxes and contributed $3,000 to an IRA.

Category	Current Situation	Long-Term Plan
Gross Income	*$38,000*	*$38,000*
− IRA contribution	*0*	*3,000*
= Adjusted gross income	*38,000*	*35,000*
− Deductions	*4,850*	*6,000*
− Exemptions	*3,100*	*3,100*
= Taxable income	*30,050*	*25,900*
Tax liability (based on applying tax rates to the taxable income)	*4,250.00*	*3,527.50*

Total Tax Savings = *$722.50 per year*

Decisions

Decisions Regarding Tax Savings for This Year:

I currently qualify for no tax savings.

Decisions Regarding Tax Savings in the Future:

I can improve my cash flows over time by taking advantage of tax deductions. If I buy a home, the interest that I would pay on the mortgage loan, as well as the real estate taxes I would be assessed, is tax-deductible. The purchase of a home would likely increase my monthly cash outflows, but I would benefit from deducting the interest payments and real estate taxes as itemized deductions, thereby reducing my taxable income.

I could also benefit from contributing a portion of my income to an IRA or qualified retirement plan, since contributions can usually be made before federal income taxes are assessed. This strategy would allow me to defer some taxes, while also setting aside some funds for retirement.

As my income increases, my tax bracket may increase. I need to maximize my potential tax savings to limit the taxes I will pay. I should contribute the maximum allowable amount to my retirement plan (without compromising my cash budget) so that I can take full advantage of the related tax savings. Also, I hope to buy a home in the future. The interest I will pay on a mortgage loan for this home will be high, but I will enjoy tax savings, while also building equity in my home.

If I get married someday, our joint income would likely be subject to a higher income tax rate than my present income. However, we would likely be able to take advantage of tax savings by purchasing a home and making additional contributions to IRAs or qualified retirement plans.

DISCUSSION QUESTIONS

1. How would Stephanie's tax planning decisions be different if she were a single mother of two children?
2. How would Stephanie's tax planning decisions be affected if she were 35 years old? If she were 50 years old?

SUMMARY

The first step in filing a federal income tax return is to determine your filing status. You may have a choice, and the status chosen can affect the taxes that you owe. Gross income consists primarily of your salary, interest income, dividend income from investments in stocks, and capital gains. A short-term capital gain is realized on an asset held for a period of less than one year and is counted as ordinary income. A long-term capital gain is subject to a capital gain tax, which is generally lower than a person's ordinary income tax rate.

Your adjusted gross income is calculated by adjusting gross income for any contributions to an individual retirement account (IRA) and for some other special circumstances. The adjusted gross income must be determined because it is used to determine eligibility for personal exemptions, itemized deductions, and IRA contributions.

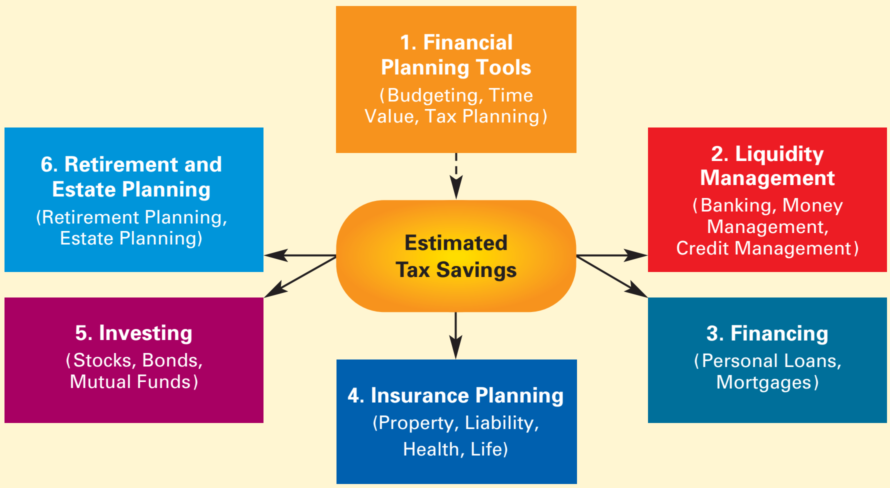
Deductions and exemptions are relevant because they are subtracted from adjusted gross income before determining your taxes. Thus, they can reduce the amount of taxes owed. Deductions include interest expenses incurred from holding a mortgage, state income taxes, real estate taxes, unreimbursed medical expenses, charitable contributions, and some other expenses. Exemptions are allowed for persons supported by the income reported on a tax return. You can elect to use a standard deduction instead of itemized deductions if doing so provides you with higher tax benefits.

Your taxable income is determined by subtracting the total value of your deductions and exemptions from your adjusted gross income. Your tax liability is dependent on your taxable income, and the tax rate applied is dependent upon your filing status and income level. The Tax Relief Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 have had an impact on many tax provisions, including tax rates, income tax brackets, and the child tax credit.

The comprehensive example illustrates how your income tax is reduced if you have various deductions that you can itemize or if you have exemptions.

INTEGRATING THE KEY CONCEPTS

Tax planning can be applied to all parts of your financial plan. It is useful for financing decisions because some types of financing result in interest expenses that are tax-deductible. It is used when making investment decisions because the income earned on some types of investments is exempt from taxes, and long-term capital gains are subject to lower tax rates than short-term capital gains. Tax planning is especially useful for retirement planning because most retirement plans offer some type of tax advantage. It is even useful for estate planning because some estates are subject to no or low taxes if they are properly organized.



REVIEW QUESTIONS

1. Why is it important to understand the tax consequences of your financial decisions?
2. What are FICA taxes? Describe the two portions of FICA and explain what they pay for. Who pays FICA?
3. How are FICA taxes for self-employed individuals handled?
4. Who typically files Form 1040EZ? What tax form do most other individual taxpayers file?
5. What are the five filing statuses? Briefly describe how your filing status is determined. What parts of the tax form are affected by your filing status?
6. What is gross income? List some types of income that are included in gross income. What are some types of payments that you might receive that would *not* be included in gross income?
7. What are capital gains? When is a capital gain considered short-term? When is it considered long-term? Why is this distinction important?
8. How is adjusted gross income determined?
9. What is a standard deduction? What is the standard deduction based on?
10. What are itemized deductions? How do itemized deductions relate to standard deductions? Provide some examples of itemized deductions.
11. What is an exemption? How many exemptions may a taxpayer claim?
12. How is taxable income calculated?
13. What is meant by a progressive tax system? What is a marginal tax bracket?
14. What is the difference between a tax deduction and a tax credit? Which is more valuable?

15. List some common types of tax credits.
16. Which of the following would be included in gross income?

Salary	Prizes
Business income	Tips
Veteran's benefits	Welfare benefits
Alimony	Dividend income
Child support	

17. Distinguish between interest income and dividend income. Does their treatment differ for tax purposes?
18. List the four classifications of deductible medical expenses. Are your total medical expenses deductible?
19. What is the difference between the tax consequences for short-term and long-term capital gains?
20. What form must be filed with the IRS for itemized deductions?
21. What is the purpose of income tax? Who administers the federal tax system?

FINANCIAL PLANNING PROBLEMS

1. Janet makes $450 per week. How much will be withheld from her weekly check for Social Security tax? Medicare tax? Total FICA taxes?
2. Avery makes $27,000 per year. How much can he expect to contribute to FICA taxes this year? How much will his employer contribute?
3. Nolan is self-employed as a carpenter. He made $42,000 last year. How much did he contribute to FICA taxes last year?
4. Larry is in a 15 percent marginal tax bracket. Last year, he sold stock that he had held for nine months for a gain of $1,900. How much tax must he pay on this capital gain? How much would the tax be if he had held the stock for 13 months?
5. Stuart is in the 25 percent tax bracket. Recently, he sold stock that he had held longer than a year for a gain of $20,000. How much tax will Stuart pay on this gain?
6. Jim sold a stock that he held for 11 months at a capital gain of $10,000. He is in the 25 percent marginal tax bracket. What taxes will he pay on this gain?
7. Teresa and Marvin are married and file a joint return. The standard deduction for their filing status is $9,700. They have the following itemized deductions:

Medical bills above the 7.5% limit	$400
Interest expense	3,500
State income taxes	1,500
Miscellaneous deductions	250

   Should Teresa and Marvin itemize their deductions or use the standard deduction?
8. Martha's adjusted gross income is $24,200. She has $1,800 in unreimbursed medical expenses. How much in medical expenses can Martha claim as an itemized deduction?
9. Jerry's adjusted gross income is $16,700. Jerry has $1,800 in unreimbursed medical expenses. How much can Jerry claim as an itemized deduction?
10. Nick Peters is married and has three children in college. His wife is a homemaker. Nick has adjusted gross income of $37,400. If Nick's standard deduction is $9,700, his itemized deductions are $11,200, and he gets an exemption of $3,100 per dependent, what is his taxable income?
11. Using the information in problem 10, if Nick's itemized deductions increase by $2,000, how will his taxable income be impacted?
12. Martin has a marginal tax rate of 25 percent. He suddenly realizes that he neglected to include a $1,000 tax deduction. How will this oversight affect his taxes?
13. If Martin (from problem 12) had forgotten a $1,000 tax credit (instead of a $1,000 tax deduction), how would his taxes be affected?
14. Tracy is single and has an adjusted gross income of $37,000 this year. Tracy is gathering information for her current year's tax return and has the following items:

Unreimbursed medical expenses	$3,000
State income tax	1,850
Interest expense (first mortgage)	3,040
Interest expense (second mortgage)	1,200
Real estate tax	700
Interest expense—car loan	550
Interest expense—credit card	125
Gifts to charity	300

How much may Tracy claim as itemized deductions?

15. Using the information in problem 14, if Tracy's standard deduction is $4,850 and her exemption is $3,100, what is her taxable income?

FINANCIAL PLANNING ONLINE EXERCISES

1. Go to http://taxes.yahoo.com/calculators/.
   a. Using the Refund Estimator for the current year, input the following information and calculate the estimated taxes:

Filing status:	Single
Exemptions:	Yourself
Income:	$50,000
Adjustments:	IRA contribution $3,000
Deductions:	Standard deduction
Credits:	Zero
Other taxes:	Zero

   b. Estimate the taxes using all the above information except the $3,000 IRA contribution.
   c. You can input your personal tax information to estimate your taxes. Calculate your taxes with and without a $3,000 IRA contribution to assess the impact of IRA contributions on taxes.
2. Go to http://taxes.yahoo.com.
   a. Click on Tax Prep Checklist and view the data. What documents do you need to prepare a tax return?
   b. Find the "Tax Tips" section. Under "Charitable Contributions," review the recommendations. How can you use this information to save on taxes?
   c. Under "Education," look up the allowable credits and deductions for educational expenses. What information could you use in preparing your tax return?
   d. Click on "Retirement Planning" and read the tips for saving on taxes while saving for retirement. How can you use this information to lower your taxes?
   e. Click on "Tax Calendar" and review the important tax dates for the current year's Tax Return. Can you make use of this information in your tax planning?

BUILDING YOUR OWN FINANCIAL PLAN

By properly managing your tax situation, you can significantly improve your annual cash flow situation and enhance your ability to achieve your goals in a timely fashion.

First, using the template provided for this chapter in the *Financial Planning Workbook* and on the CD-ROM, estimate your federal income tax liability based on the 2004 guidelines presented in this chapter or current regulations and rates.

Next, explore ways in which you can utilize various tax advantage devices such as 401(k)s, IRAs, and employer matches to not only reduce your current tax liability, but also achieve future financial goals. Web sites like [illegible] also provide helpful tips for reducing your tax liability. List the tax advantage options that may prove beneficial in reaching your goals established in Chapter 1 on the template provided for this chapter. Undoubtedly, you will find that the long-term goals have the most options. The template will be modified as you proceed through this course and become aware of other tax advantage options.

This exercise will give you some insights into what employee benefits you should look for from a prospective employer. Talk to friends and relatives and find out how they reduce their taxes and achieve financial goals.

Another crucial element of proper tax management is the selection of an appropriate tax preparer. Your options vary from doing your own tax return to engaging the services of a certified public accountant. When you begin your search for a tax preparer, you will find some questions in the template for this chapter that should aid your selection. Once you have selected a tax preparer whom you trust, it is really not necessary to periodically review this decision. You should, however, remember that as your personal financial situation becomes more complex (e.g., you have a home, you itemize, your portfolio grows to include international stocks), you may need a tax preparer with more advanced skills. Be sure that the skills of your tax preparer are a match for the sophistication level of your personal financial situation.

THE SAMPSONS—A CONTINUING CASE

Dave and Sharon Sampson want to determine their taxes for the current year. Dave will earn $48,000 this year, while Sharon's earnings from her part-time job will be $12,000. Neither Dave nor Sharon contributes to a retirement plan at this time. Recall that they have two children. Assume child tax credits are currently $1,000 per child. The Sampsons will pay $6,300 in home mortgage interest and $1,200 in real estate taxes this year, and they will make charitable contributions of $600 for the year. The Sampsons are filing jointly.

1. Help the Sampsons estimate their federal taxes for this year by filling in the template provided in the *Financial Planning Workbook* and on the CD-ROM shrink-wrapped with your text.
2. The Sampsons think that it will be very difficult for them to pay the full amount of their taxes at this time. Consequently, they are thinking about underreporting their actual income on their tax return. What would you tell the Sampsons in response to this idea?

IN-TEXT STUDY GUIDE

True/False:

1. By understanding how your income may be taxed, you can make decisions that reduce your taxes, enhance your after-tax cash flows, and therefore enhance your wealth.
2. FICA is a government health insurance program that provides health insurance for people over age 65 and provides payments in the case of illness.
3. An employer must match the Medicare taxes that each of its employees pays.
4. Married people can combine their incomes and file a joint return, or each can file a separate tax return.
5. Gross income includes all income from any sources.
6. Interest income earned from investments in bonds issued by the federal government is normally exempt from federal taxation.
7. A standard deduction is an amount to be deducted to determine your FICA tax.
8. Itemized deductions are specific expenses that can be deducted to reduce taxable income.
9. A marginal tax rate of 30 percent means that all previous income has been taxed at a 30 percent tax rate.
10. The U.S. tax system is progressive, meaning that higher incomes are taxed at higher tax rates.
11. If you are a qualifying widow(er) with a dependent child, you are entitled to use the joint tax rates for two years following the death of your spouse, assuming that you remarried.
12. Contributions to your employer-sponsored retirement account, whether made by you or your employer, are not subject to income taxes until those funds are withdrawn from the retirement account.

Multiple Choice:

1. Which of the following will not affect the amount of taxes you pay?
   a. taking a third job to enhance your wealth
   b. purchasing a home that will be financed with a mortgage
   c. contributing a portion of your salary to your retirement account
   d. All of the above will affect the amount of taxes you pay.
2. _________ uses its funds to make payments to you upon retirement (subject to age and other requirements).
   a. FICA
   b. The Social Security System
   c. Medicare
   d. None of the above

The following information refers to questions 3 and 4.

Billy Benson earned a salary of $52,000 this year.

3. Billy will pay FICA taxes for Social Security in the amount of
   a. $3,224.
   b. $32,240.
   c. $754.
   d. $7,540.
4. Billy will pay FICA taxes (excluding the employer's contribution) for Medicare in the amount of
   a. $3,224.
   b. $32,240.
   c. $754.
   d. $7,540.
5. Self-employed individuals pay FICA taxes at a rate of
   a. 7.65 percent.
   b. 1.45 percent.
   c. 15.30 percent.
   d. 2.90 percent.
6. __________ is not a filing status.
   a. Single
   b. Married filing separate returns
   c. Qualifying widow(er) with independent child
   d. Head of household
7. Individuals can earn __________ income from investments in various types of savings accounts at financial institutions.
   a. interest
   b. dividend
   c. wage
   d. option
8. Oliver Ontario purchased stock 13 months ago. Since then, the stock has increased in value by $35,000. Oliver is in the 25 percent tax bracket. If Oliver sells the stock today, he will pay a capital gains tax of
   a. $9,800.
   b. $5,250.
   c. $3,500.
   d. none of the above

The following information refers to questions 9 and 10.

Humphrey Porter earned a salary of $70,000 this year. Additionally, Humphrey had $1,000 in interest income, $2,000 in dividend income, and a short-term capital gain of $5,000.

9. Humphrey's gross income for this year is
   a. $72,000.
   b. $75,000.
   c. $78,000.
   d. $76,000.
10. Assume Humphrey filed as head of household this year. If he took the standard deduction and had a personal exemption and an exemption for one dependent, his taxable income for this year is
    a. $70,950.
    b. $68,900.
    c. $68,200.
    d. $64,650.
11. __________ are specific expenses that can be deducted to reduce taxable income.
    a. Standard deductions
    b. Itemized deductions
    c. Exemptions
    d. Adjusted expenses
12. Which of the following is not a typical type of itemized deduction?
    a. interest expenses on a car loan
    b. real estate taxes imposed by the county where the real estate is located
    c. medical expenses incurred to affect any structure or function of the body
    d. charitable gifts to certain qualified organizations
13. Melanie incurred interest expenses of $8,000 on a mortgage loan during this year. Furthermore, she incurred state income taxes of $1,000. She also contributed $500 to the American Cancer Society. Based on this information, Melanie's itemized deductions for this tax year are
    a. $1,500.
    b. $9,000.
    c. $8,000.
    d. $9,500.
14. Ron Bamberg had an adjusted gross income of $90,000 for one year. In that year, his deductions and exemptions totalled $8,100. Ron's taxable income for the year was
    a. $83,930.
    b. $81,900.
    c. $82,950.
    d. $87,250.
15. Mira had taxable income of $150,000. Bob had taxable income of $30,000. Mira's marginal tax rate is __________ Bob's.
    a. the same as
    b. lower than
    c. higher than
    d. none of the above

16. A(n) __________ does not represent an itemized deduction.
    a. child tax credit
    b. interest expense
    c. state tax
    d. real estate tax
17. Which of the following is incorrect with respect to 529 plans?
    a. They allow substantial tax benefits for parents who wish to set aside funds to cover their children's college expenses in the future.
    b. All parents are eligible for the 529 plan, regardless of their income amount.
    c. Parents can contribute up to $200,000 or more in the account, depending on the state's requirements.
    d. The income contributed to 529 plans is subject to federal taxation.
18. The __________ is a special credit for taxpayers who earn low incomes.
    a. child tax credit
    b. Medicare credit
    c. earned income credit
    d. college expense credit
19. Lance Cage is a married individual filing separately. Lance is 68 years old. The amount of standard deductions Lance qualifies for is
    a. $4,850.
    b. $5,800.
    c. $7,850.
    d. $8,800.

The following information refers to questions 20 and 21.

Frank Shaeffer earned a salary totaling $80,000.

20. Frank's Social Security taxes are
    a. $1,160.00.
    b. $4,960.00.
    c. $4,501.20.
    d. $6,120.00.
21. Frank's total FICA taxes (excluding the employer's contribution) are
    a. $6,120.00.
    b. $5,661.20.
    c. $5,553.90.
    d. none of the above
22. __________ reduce taxable income even if the taxpayer does not itemize.
    a. Exemptions
    b. Capital gains
    c. Credits
    d. None of the above

PART 1: BRAD BROOKS—A CONTINUING CASE

Your childhood friend, Brad Brooks, has asked you to help him gain control of his personal finances. Single and thirty years old, Brad is employed as a salesperson for a technology company. His annual salary is $48,000. He claims no exemptions (he enjoys the big refund check in May), and after Social Security, Medicare, and federal, state, and local income taxes, his monthly disposable income is $2,743. Brad has recently moved from his comfortable two-bedroom apartment with rent of $600 per month to a condo that rents for $1,000 per month. The condo is in a plush property owner's association with two golf courses, a lake, and an activity center. You review his other monthly expenses and find the following:

Renter's insurance	$20
Car payment (balance on car loan $10,000; market value of car $11,000)	500
Utilities (gas, electric, cable)	100
Cell phone (personal calls)	250
House phone	30
Food (consumed at home)	200
Clothes	100
Car expenses (gas, insurance, maintenance)	250
Entertainment (dining out, golf, weekend trips)	400

Brad is surprised at how much money he spends on clothes and entertainment. He uses his credit cards for these purchases (the balance is $8,000 and climbing) and has little trouble making the required monthly payments. He would, however, like to see the balance go down and eventually pay it off completely.

Brad's other goal is to save $4,000 a year so that he can retire 25 years from now. He would like to start saving in five years, as he does not think the delay will affect the final amount of retirement savings he will accumulate.

Brad currently has about $4,000 in his checking account and $200 in his savings account (the balance necessary to receive fee-free checking). He has furniture valued at $1,500 and owns $1,300 of tech stocks, which he believes have the potential to make him rich.

Brad has asked you to do the following:

1. a. Prepare personal financial statements for Brad, including a personal cash flow statement and personal balance sheet.
   b. Based on these statements, make specific recommendations to Brad as to what he needs to do to achieve his goals of paying off his credit card balance and saving for retirement.
   c. What additional goals could you recommend to Brad for both the short and the long term?
2. Consider Brad's goal to retire in 25 years by saving $4,000 per year starting five years from now.
   a. Based on your analysis of Brad's cash flow and your recommendations, is saving $4,000 per year a realistic goal? If not, what other goal would you advise?
   b. In order for Brad to know what his $4,000 per year will accumulate to in 20 years, what additional assumption (or piece of information) must he make (or have)?
   c. Assuming that Brad invests the $4,000 per year for 20 years starting five years from now in something that will return 12 percent, how much will he have in 25 years?
   d. Compare the alternative of investing $4,000 every year for 25 years beginning today with Brad's plan to invest $4,000 every year for 20 years beginning five years from now. How much in additional funds will Brad have to save each year to end up with the same amount that he would have in 25 years if he started saving now instead of five years from now? (Again assume a 12 percent annual return.)

3. Develop three or four suggestions that could help Brad reduce his income tax exposure. List the pros and cons of each.
4. Would any of your recommendations in questions 1 through 3 change if Brad were 45? If he were 60? Why or why not?
5. After you informed Brad of his negative monthly net cash flow, he indicated that he may delay paying his credit card bills for a couple of months to reduce his cash outflows. What is your response to your friend's idea?