

CHAPTER 8 TAXATION OF INDIVIDUALS

I. Individual Taxpayers

A. Unique Characteristics

1. **Individuals engage in business activities, production of income activities, and personal activities.**
2. **In general, personal expenses and losses are not deductible. However, the tax law does allow certain types of expenditures to be deducted if the taxpayer itemizes deductions (i.e. total allowable itemized deductions > standard deduction).**

II. Income Tax Calculation

Exhibit 8-1
INDIVIDUAL INCOME TAX CALCULATION

Gross Income (All Income Received Less Exclusions)		\$ XXX
LESS: Deductions FOR Adjusted Gross Income		<u>(XXX)</u>
EQUALS: Adjusted Gross Income (AGI)		\$ XXX
LESS: Deductions FROM Adjusted Gross Income		
THE GREATER OF:		
1. Itemized Deductions		
OR		
2. Applicable Standard Deduction		(XXX)
LESS: Personal and Dependency Exemptions		<u>(XXX)</u>
EQUALS: TAXABLE INCOME		<u>\$XXX</u>

Calculation of Tax Due (Refund)

Tax on Taxable Income (From Rate Schedule/Table)		\$XXX
ADD: Additional Taxes		XXX
LESS: Tax Credits		<u>(XXX)</u>
EQUALS: NET TAX		\$XXX
LESS:		
Amounts Withheld For Payment of Tax		(XXX)
Estimated Tax Payments		<u>(XXX)</u>
EQUALS: TAX DUE (REFUND OF TAX PAID)		<u>\$XXX</u>

III. Personal and Dependency Exemptions

- A. **Personal Exemptions - Taxpayer(s) filing a return are generally allowed to deduct \$3,650 (\$3,500 in 2008) as an exemption amount to cover basic living costs. (Note that dependents are not allowed personal exemptions).**
- B. **Dependency Exemptions - For each dependent of the taxpayer, an additional \$3,650 is allowed as an exemption deduction.**
- C. **Dependency Tests - NEW – a dependent must be either a Qualifying Child or a Qualifying Relative. Five different tests for each. All 5 Tests must be met!**
 - 1. **Qualifying child**
 - a. **Age test**
 - 1) **Under age 19**
 - 2) **Full-Time Student under age 24**
 - b. **Non-support test**
 - 1) **Dependent cannot provide more than $\frac{1}{2}$ of their own support**
 - A) **Scholarships are not support for this test**
 - c. **Relationship test**
 - 1) **Taxpayer's son, daughter stepson, stepdaughter, eligible foster child, brother, sister, stepbrother, stepsister, or descendant of such relative**
 - d. **Principal Residence Test**
 - 1) **Must live with taxpayer $> \frac{1}{2}$ the year**
 - A) **Temporary absence for school, illness, military service not considered to be living away from residence**
 - e. **Citizen or Residency test**
 - 1) **U.S. citizen or resident; resident of Canada or Mexico**

2. Qualifying Relative – Five Tests

- a. **Gross Income Test - Gross Income (as defined for tax purposes) must be \leq exemption amount (\$3,650 in 2009).**
 1. **This test is waived for:**
 - A) **Child of the taxpayer < 19**
 - B) **Full-Time Student < 24**
- b. **Support Test - Must provide $> 1/2$ of the support of the dependent. Only amounts spent on support count in determination of the support test. Gross Income of the dependent is irrelevant for this test.**
 1. **Multiple Support Agreements**
 2. **Children of Divorced Parents - Custodial parent receives dependency exemption regardless of actual level of support. Custodial parent may give exemption to Non-custodial parent by written agreement (attached to return each year).**
- c. **Relationship or Member of Household Test -- A dependent must be either a relative of the taxpayer or a member of the taxpayer's household for the entire year.**
- d. **Citizen or Residency Test -- A dependent must be either (a) a U.S. citizen or (b) a resident of the U.S., Canada, or Mexico.**
- e. **Joint Return Test -- The dependent cannot file a joint return with their spouse for the exemption year in question. EXCEPTION: If the married dependents are not required to file a return, but only do so to obtain a refund of taxes paid, and no tax liability would exist for either spouse if each filed a separate return.**

IV. Filing Status

- A. **Filing Status affects a taxpayers effective tax rate, standard deduction amount, and several other deductions on a tax return. There are two basic types of taxpayers - Married/Unmarried. Your status is determined on the last day of the tax year and by state law.**

B. Married Taxpayers

1. Joint Returns

- a. Surviving Spouse - May file at joint return rates for two years following the year of death of spouse if a dependent child lives in the household (would file joint in year of death).**

- 2. Separate Returns -- Primary use is in situations of marital or financial disagreement in which the husband and wife cannot agree to file together and are not divorced or legally separated by year's end.**

C. Unmarried Taxpayers

1. Single

- 2. Head of Household - an unmarried taxpayer who supports another individual. To qualify for HofH status, you must maintain a home that is the principal residence for more than 1/2 the year of:**

- a. A dependent of the taxpayer**

- 1) Parents who qualify as dependents do not have to live in the household.**

- b. Unmarried child or other direct descendent who does not qualify as a dependent if they live in the home for more than half of the year.**

- 3. Abandoned Spouse - gets HofH status**

- a. Married taxpayer whose spouse did not live in the household during the last six months of the year. A dependent child must live in the household for more than half the year.**

VI. Deductions From AGI - Itemized v. Standard Deduction

A. Standard Deduction Amounts

TABLE 8-1
STANDARD DEDUCTION AMOUNTS - 2008 & 2009

<u>Filing Status</u>	<u>2008</u>	<u>2009</u>
Single Taxpayers	\$ 5,450	\$ 5,700
Married Taxpayers, Filing Jointly	10,900	11,400
Married Taxpayers, Filing Separately	5,450	5,700
Head of Household	8,000	8,350
Surviving Spouse	10,900	11,400

2. Additional Standard Deduction (> 65; blind)

1. Single - \$1,400 per condition (\$1,350 in 2008)
2. Married - \$1,100 per condition (\$1,100 in 2008)

VII. FROM AGI Deductions (Itemized Deductions)

A. Specifically Allowable Personal Expenses and Production of Income Expenses (other than rental and royalty expenses).

B. Taxpayers will itemize only when Total Deductible Itemized Deductions exceed Standard Deduction.

1. Several of the itemized deductions are limited to a deduction amount that exceeds a specified percentage of AGI.

C. Unreimbursed Medical Expenses - Deductible to extent the allowable unreimbursed expenses exceed 7 1/2% of AGI.

1. Only prescription drugs and insulin qualify as allowable medicine and drug costs.
2. Also includes the cost of health and accident insurance premiums and transportation costs of 24 cents per mile for travel to and from the place of medical care.

D. Taxes - Amounts Paid-In during the year for State & Local Income Taxes and Property Taxes are deductible.

1. State Income Taxes - Tax Benefit Rule

2. Property Taxes - Tax must be ad valorem.

a. Property bought or sold during the year.

3. *Sales Tax (New) (Exhibit 8-3) – Can deduct sales tax paid in lieu of state income tax*

a. Use actual receipts or IRS table to determine sales tax paid.

b. Large purchases (car, motorhome, etc.) added to table amount.

c. In states with an income tax, this would not generally be desirable unless there is a large purchase during the year.

E. Interest - Only Qualified Home Mortgage Interest and Investment Interest is deductible.

1. Qualified Home Mortgage Interest - Interest on debt secured by taxpayer's residence and one other residence (as defined for vacation homes) is deductible.

a. Interest on Acquisition Indebtedness of up to \$1,000,000 is deductible; interest on excess debt (> \$1,000,000) is personal and nondeductible.

1) Points paid to acquire an initial mortgage are deductible. Points paid to refinance an existing mortgage must be amortized over term of new loan.

b. Interest on up to \$100,000 of Home Equity Loan Debt is deductible. However, Acquisition Debt + Home Equity Debt cannot exceed Fair Market Value of the Property.

2. Investment Interest - Interest paid on money borrowed to produce investment income (portfolio income) is deductible.

- a. Limitation - Investment Interest Deduction cannot exceed the taxpayer's Net Investment Income (NII)**
 - 1) $NII = \text{Investment Income} - \text{Other Investment Expenses}$**
 - 2) Any investment interest in excess of the limitation may be carried forward to subsequent years.**
 - 3) Effect of 2% miscellaneous limit**

F. Charitable Contributions - Exhibit 8-4

G. Personal Casualty and Theft Losses

- 1. Total Personal Casualty and Theft Losses for the year are limited to the total loss in excess of 10% of AGI.**

EXHIBIT 8-4
SUMMARY OF CHARITABLE CONTRIBUTION RULES

Examples of Qualified Charities:

Churches, Temples, Synagogues
 Salvation Army, Red Cross, CARE, Goodwill, United Way,
 Boy Scouts, Girl Scouts, Boys Club of America
 Fraternal Orders (if gift used for charitable purpose)
 Nonprofit Schools and Hospitals
 Veteran's groups
 Certain Cultural groups
 Federal, State, and Local Governments

Examples of Nonqualifying Organizations:

Chamber of Commerce and other business
 leagues or organizations
 Civic Leagues
 Communist Organizations
 International organizations
 Social clubs
 Country clubs

Examples of Allowable Contribution Items:

Cash
 Clothing
 Furniture
 Fixtures
 Inventory
 Real Property
 Stocks, Bonds
 Paintings, works of art
 Jewelry
 Automobiles
 Appliances
 Out of pocket costs for performing charitable work - special
 uniforms, mileage, etc.

Items That are not Deductible:

Political Contributions
 Raffle, bingo, or lottery tickets
 Tuition to a private school
 The value of a person's time
 Value of blood donated to a blood bank or Red
 Cross
 Gifts to individuals

<u>Type of Property:</u>	<u>Amount of Contribution:</u>	<u>Maximum Deduction (Limit):</u>
Cash	Amount Contributed	50% of Adjusted Gross Income
Ordinary Income or Short-Term Capital Gain Property	The lower of: 1. The fair market value at the time of the contribution. or 2. The Adjusted Basis of the property.	50% of Adjusted Gross Income
Long-Term Capital Gain Property	Fair Market Value at the Date of Contribution An election can be made to reduce the amount of the contribution to the Adjusted Basis of the property.	30% of Adjusted Gross Income 50% of Adjusted Gross Income

H. Miscellaneous Itemized Deductions - Exhibit 8-5

1. Fully Deductible Miscellaneous

2. Partially Deductible Expenses - Only the allowable expenses in excess of 2% of AGI are deductible.

- a. For purposes of the investment interest calculation, only the investment expenses that are actually deductible after considering the 2% limit are used to calculate NII.
- b. All other allowable miscellaneous itemized deductions must be taken against the 2% limit first, in determining the amount of deductible investment expenses for purposes of the NII calculation.

EXHIBIT 8-5
MISCELLANEOUS ITEMIZED DEDUCTIONS

Fully Deductible Miscellaneous Expenditures:

Gambling Losses (to extent of gambling winnings)
 Impairment related work expenses of a handicapped person
 Unrecovered investment in annuity contracts due to death

Partially Deductible Expenditures:

Employee Business Expenses

Certain Employment Agency Fees
 Certain employment-related education
 Dues to professional organizations
 Subscriptions to professional journals
 Small tools and supplies
 Uniforms not adaptable to general use
 Union Dues and expenses

Nondeductible Expenditures

Burial or funeral expenses
 Fees and Licenses, such as marriage licenses
 and dog tags
 Fines and Penalties
 Home repairs
 Home insurance
 Rent on a personal residence

Investment Expenses

Legal and accounting fees
 Safe deposit box rental
 Investment Counsel fees
 clerical help and office rent in caring for investments
 Fees paid in connection with property held for the production
 of income

Other Allowable expenses

Hobby-related deductions
 Fees for tax advise
 Fees for tax preparation

VII. Itemized Deduction & Exemption Reductions - High Income Taxpayers

- A. If AGI > \$166,800 in 2009 (\$159,950 in 2008), total itemized deductions must be reduced by 3% of AGI in excess of \$166,800 (\$159,950 in 2008).**
- 1. Medical Deductions, Investment Interest Deductions, Gambling Losses, and Casualty Losses are not subject to the reduction.**
 - 2. Maximum Reduction - 80% of remaining deductions.**
- B. When AGI > Applicable Threshold Amount (Table 8-3), 2% of the total exemption amount is lost for each \$2,500 (or portion thereof) of AGI in excess of threshold amount.**

TABLE 8-3

2009 THRESHOLD AGI FOR EXEMPTION PHASE-OUT

<u>Filing Status</u>	<u>Threshold Amount</u>	<u>Phase-Out Ends</u>
Single	\$ 166,800	\$ 289,300
Head of Household	\$ 208,500	\$ 331,000
Married, Filing Jointly	\$ 250,200	\$ 372,700
Married, Filing Separately	\$ 125,100	\$ 186,350
Surviving Spouse	\$ 250,200	\$ 372,700

2008 THRESHOLD AGI FOR EXEMPTION PHASE-OUT

<u>Filing Status</u>	<u>Threshold Amount</u>	<u>Phase-Out Ends</u>
Single	\$ 159,950	\$ 282,450
Head of Household	\$ 199,950	\$ 322,450
Married, Filing Jointly	\$ 239,950	\$ 362,450
Married, Filing Separately	\$ 119,975	\$ 181,225
Surviving Spouse	\$ 239,950	\$ 362,450

NOTE: These phase-outs are phased-out (figure that one out) over a 5 year period beginning in 2006. i.e., they won't be there in 2010! For tax years 2008 and 2009, the calculated amount of the exemption deduction phase-out is reduced by two-thirds.

VIII. Exemption & Standard Deduction Restrictions on Dependents

- A. No Personal Exemption Deduction allowed if you can be claimed as a dependent of another.**

B. Standard Deduction is the greater of:**1. \$950 (\$900 in 2008)****or****2. Dependents Earned Income + \$300 limited to the single standard deduction****IX. Calculating the Tax****A. Rate Schedules/Tax Table (TI < \$100,000)****B. Tax on Unearned Income of a Minor Child (<14) [Kiddie Tax]****1. The Net Unearned Income (NUI) of a Minor Child is taxed at the parents marginal tax rate.****2. $NUI = UI - \$950 - (\text{greater of } \$950 \text{ or cost of producing the UI})$** **a. If Unearned Income > \$1,900, then the "Kiddie Tax" applies.****b. When "Kiddie Tax" applies, at least \$950 of income will still be taxed at the child's rate (10%).****c. Income taxed at a preferential rate (dividends, LTCG) must be apportioned by the relationship to total income.****C. Income Tax Credits****1. Direct reduction of tax liability****a. Refundable v. Nonrefundable****2. Child Credit****a. Credit of \$1,000 for each qualifying child****b. Qualified child - same as for dependency exemption, except****1) Must be < 17 years old****2) Must be a citizen or resident of U.S.****c. Phase-out - \$50 for each \$1,000 of AGI that exceeds**

- 1) unmarried - \$75,000
- 2) married - \$110,000

c. Refundable credit - maximum

- 1) 1 or 2 children – 15% (earned income - \$12,550)
- 2) > 2 children – greater of formula for 1 or 2
or
SS tax paid – earned income credit

3. Earned Income Credit (EIC) (See Exhibit 8-6)

a. Refundable credit that targets low income taxpayers

b. Eligibility

- 1) > 1/2 year in U.S.
- 2) > 24 and < 65 (taxpayer or spouse)
- 3) Can't be a dependent of another taxpayer
- 4) Portfolio income < \$3,100 (2009), \$2,950 (2008)

c. Credit is based on the greater of taxpayer's earned income or adjusted gross income and the number of qualifying children living in the home.

- 1) <19 (24 for full-time student) and be a child, stepchild, foster child, or lineal descendent, and reside in the home > 1/2 of tax year

d. Use Table in Appendix to determine amount of credit

4. Child and Dependent-Care Credit

a. A credit for child care expenses that enable the taxpayer to work

- 1) Qualifying individual must be a dependent < 13 or a dependent or spouse who is mentally or physically handicapped

- b. Credit is 35% of qualified expenditures**
 - 1) Lesser of \$3,000 (\$6,000 > 1 qualifying individual) or earned income**
 - 2) 35% rate is reduced by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. Minimum credit is 20% (reached at AGI of \$43,000).**

5. Higher Education Tax Credits - 2 credits for higher education expenses.

- a. Only one credit can be claimed for each qualifying individual.**
- b. Married taxpayers must file a joint return to take the credit.**
- c. Qualified education expenses only include tuition and related fees.**
 - 1) Activity fees and tuition for sports, games, or hobbies not eligible.**
 - 2) Only out-of-pocket costs are eligible.**
 - a) Must reduce tuition by scholarships.**
 - b) Amounts paid by employer educational assistance plan not eligible (unless taxable).**
 - c) Amounts paid with loans are eligible.**
 - 3) Amounts deducted for AGI (Chapter 6 deduction for higher education expenses) aren't eligible for tax credits (no double benefit)**
- d. Expenses of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer are eligible.**
 - 1) If a student is claimed as a dependent by another taxpayer, the student cannot claim the credit; it must be claimed by the taxpayer claiming the dependency exemption. Any qualifying expenses paid by the student are treated as being paid by the taxpayer claiming the dependency exemption.**

- e. Both credits are subject to a phase-out.
 - 1) Allowable credit is phased-out ratably for married taxpayers with adjusted gross income between \$100,000 and \$120,000 and for all other taxpayers with adjusted gross income between \$50,000 and \$60,000.

6. HOPE Scholarship Tax Credit (HSTC)

- a. Available for the first two years of undergraduate study.
- b. A qualifying student must be enrolled on at least a half-time basis for at least one semester during the academic year.
- c. Credit is 100% of first \$1,200 of qualifying expenses and 50% of next \$1,200. Max Credit = \$1,800.

7. Lifetime Learning Tax Credit (LLTC)

- a. Can be claimed for expenses incurred each year for undergraduate or graduate education.
- b. In addition to students enrolled on at least a half-time basis, the credit can be claimed for a student who is less than half-time in a course(s) that helps the student acquire or improve job skills.
- c. Credit is 20% of qualifying expenses.
 - 1) Maximum qualifying expenses limited to \$10,000
Maximum credit = \$2,000
 - a) Note that maximum is based on qualifying expenses, not number of qualifying individuals.
 - b) Can take HSTC for qualifying individuals and LLTC for other individuals.

X. Filing Requirements

- A. General Rule - You must file a tax return when your gross income (as defined for tax purposes) exceeds the sum of your allowable personal exemptions (including exemption for age, but not for blindness). Note: Dependency exemptions are not taken into account for purposes of this calculation. NOTE: A dependent with unearned income must file when their gross income exceeds \$950. See Table 8-5 for specific calculations.**