

Chapter 11

Income taxation of individuals

Key Concepts

- Individuals have two sets of deductions – one *for* adjusted gross income and the other *from* adjusted gross income in determining taxable income.
- Individuals have two unique deductions from adjusted gross income, the greater of their standard deduction or itemized deductions and their exemptions, both personal and dependency. High-income taxpayers may have their exemptions and itemized deductions limited.
- To be deductible, medical expenses, casualty losses, and miscellaneous itemized deductions must exceed a certain minimum based on adjusted gross income (AGI). Interest and taxes are not limited by AGI, but high-income taxpayers may lose up to 80 percent of their deductions due to the phase out rules.
- An individual's standard deduction and the tax rate tables or schedules used to determine the gross tax liability are dependent on filing status. The five filing statuses are (1) married filing jointly, (2) married filing separately, (3) surviving spouse, (4) head of household, and (5) single.
- The taxpayer's net tax due or refund expected is the mathematical sum of the taxpayer's gross tax liability less tax credits plus additions to their taxes less tax prepayments. A positive sum is the tax due; a negative sum is the expected refund.

1. The individual tax model

Tax formula for an individual

a.1040 Let's look at page 513

b. Deductions for AGI (Allowed whether you take the standard deduction or itemize)
Educator expenses-kindergarten through 12th grade teachers may deduct up to \$250 of unreimbursed expenses for books, supplies, computer equipment, software, etc.

Interest paid on qualifying loans, including voluntary payments of interest

Annual deduction limit remains \$2,500

Phase out

Single MAGI \$50,000 – 60,000

MFJ MAGI \$100,000 – 130,000

Qualified Higher Education Expenses include tuition and fees for TP, TP's spouse, or any dependent for whom TP may claim a dependency exemption.

2002 - \$3,000

2003 - \$3,000

2004 - \$4,000

2005 - \$4,000

Single and HH MAGI cannot exceed \$65,000

MFJ MAGI cannot exceed \$130,000

In 2004 and 2005, can claim \$2000 rather than \$4000 if

Single \$65,000 – 80,000

MFJ \$130,000 – 160,000

No deduction if taxpayer claims Hope or Lifetime Learning Credit in the same year for the same student.

Archer medical savings accounts (MSA) and Health savings account (HSA)-

Taxpayers who are covered by high deductible medical insurance plans may put aside a specified amount of money in a medical savings plan on a tax-deferred basis. The contributions to and the earnings on the accounts are not taxed when withdrawn to pay medical expenses.

Penalty on early withdrawal of savings-If taxpayers make premature withdrawals from CDs or other savings accounts, they are normally assessed a penalty by the bank. Gross interest income, unreduced by the penalty, is included in income as taxable interest.

National Guard and Military reserve Travel Deduction

c. Adjusted gross income

d. Deductions from AGI
Itemized or standard and
Personal and dependency exemptions (\$3,100)

Itemized deductions are those personal expenses allowed by the IRC, such as medical, interest, property taxes, charitable contributions, personal casualty losses, and miscellaneous.

e. Determining the tax liability

2. Filing status
Married filing joint (MFJ)
Married filing separate (MFS)
Head of household (HH)
Single (S)

Married filing joint

Legally married on last day of tax year

Importance of state law

Both spouses must be US citizens or residents of US to file a joint return

Marital status is determined on date of death. Surviving spouse may file MFJ and claim 2 personal exemptions

Surviving spouse may file MFJ and use MFJ standard deduction for two years after the year of death if has at least one dependent child in the home for the entire tax year, for whom she/he pays more than one-half the cost of maintaining the home.

Married filing separate

Cannot claim the earned income credit or the child and dependent care credit
Filing separately relieves one spouse of any liability for taxes arising from the other spouse's return.

Head of household

Must be single

Must pay more than half the costs of maintaining a home in which a child or relative claimed as a dependent lives for more than half the tax year.

Your child does not have to be your dependent, unless the child is married.

Temporary absences for school, vacation, or medical care count as time lived at home.

Child includes legally adopted or stepchild. Foster child must live in the home the entire year.

A dependent parent does not have to live in the home with the taxpayer.

An abandoned spouse is a person who is married at year-end but who has

Lived apart from the spouse at all times during the last six months of the tax year and paid more than one-half the cost of maintaining a home in which the taxpayer and a dependent child lived for more than half the tax year.

Single

Whew

3. Personal and dependency exemptions- 2003 was \$3,050 and for 2004 is \$3100

Qualifying relative or member of taxpayer's household for the entire year

Support test. Taxpayer must provide more than half the support for an individual to claim a dependency exemption.

Scholarships do not count toward support.

For divorce decrees after 1984, the custodial parent is automatically granted the dependency exemption for a child.

Multiple support agreements

Gross income test

A potential dependent's GI, must be less than the amount of the exemption.

The GI test is waived for your child who is under 19 or under age 24 and was a full-time student for at least five months of the tax year.

If a person is claimed as a dependent on another person's tax return, she/he cannot take a personal exemption when computing her/his own tax liability.

Phase-out of exemptions- page 400

4. Standard deduction- page 401 See Table 11.1

Taxpayers who are 65 at the end of the tax year or who are blind are allowed an additional standard deduction:

Single get additional \$1,150 in 2003 and \$1,200 in 2004

MFJ get \$950 for 2003 and 2004

In 2004, the standard deduction for dependents is limited to the greater of \$800 or their earned income for the year plus \$250 (up to their otherwise allowable standard deduction).

Earned income includes salaries, wages, tips, and net business income, but not net rental income, interest, dividends, or capital gains.

The standard deduction for a dependent cannot exceed the standard deduction allowed a taxpayer in that filing status.

5. Itemized deductions- Table 11.2 is very good.

Medical expenses if exceed 7.5% of AGI

Medical

Dental

Prescription drugs and insulin

Health insurance premiums if paid out of after tax income

Not disability insurance premiums

Long term care insurance premiums are partially deductible

Wheelchairs, eyeglasses, contact lenses, crutches, false teeth, hearing aids, and artificial limbs are deductible.

Medical expenses that are charged on a credit card are deemed paid when charged.

Medical expenses paid in advance are not deductible until the year of treatment unless prepayment is required.

When medical expenses are paid in one year and reimbursement is received in the next year, the tax benefit rule requires that the reimbursement be included in the taxpayer's income to the extent the prior deduction resulted in a tax benefit.

Taxes

State, local and foreign real property taxes

State and local personal property taxes

State, local and foreign income taxes

Other state, local and foreign taxes that are incurred in the context of a trade or business or other income producing property, so excise and sales taxes paid by a business would be deductible.

FEDERAL INCOME TAXES ARE NOT DEDUCTIBLE ON A FEDERAL INCOME TAX RETURN!!!!!!

Interest expense. What is the nature of the underlying debt?

Investment interest

Interest on loans to acquire or hold investment property

Margin interest paid to a broker to borrow against a brokerage account

Deductibility of investment interest is limited to a taxpayer's net investment income for the year.

Net investment income is the excess of gross investment income over deductible investment expenses (excluding interest).

Investment interest that is not currently deductible can be carried forward indefinitely.

Because miscellaneous itemized deductions are deductible only to the extent that they exceed 2% of AGI, the maximum amount of investment expenses that the taxpayer must deduct from gross investment income to determine net investment income is the lesser of the following:

The total of such investment related expenses or

Net miscellaneous itemized deductions that are deductible after reduction of the 2% AGI floor.

Qualified residence interest

Debt secured by TP's residence to acquire, construct, or substantially improve such residence.

Interest on debt principal up to \$1,000,000 is deductible.

TP may combine acquisition indebtedness on no more than 2 homes to reach \$1,000,000.

Nondeductible interest cannot be carried forward.

Home equity line interest expense is deductible on the lesser of \$100,000 or the value of the home reduced by any acquisition indebtedness.

Charitable contributions

Deductible up to 50% of AGI. Excess contributions can be carried forward for up to 5 years.

Cash

Personal services

Rent free use of TP's property

Unreimbursed expenses related to the performance of charitable services

Property. The donation value of property other than capital assets is the lesser of the property's FMV or basis.

Value of LTCG property is FMV.

Maximum is 30% of AGI.

Considered last.

STCG, capital loss property, and ordinary income property are limited to the lesser of FMV or basis.

Casualty and theft losses

Lesser of basis or decline in FMV, reduced by insurance proceeds

\$100 floor applies to each casualty

Then reduced by 10% of AGI

Miscellaneous

Reduced by 2% of AGI

Employment related expenses

Investment related

Expenses related to the determination, collection, or refund of any tax

Phase-out of itemized deductions for high-income taxpayers. Page 411

Medical, casualty losses, and investment interest are not subject to the phase-out.

6. Computing the tax. See tax rate schedules on page 412.

7. Tax credits

Child credit

\$1000

A nonrefundable tax credit for each of TP's dependent children under 17.

Phased out when AGI hits a certain dollar amount (\$50 for every \$1000 over)

MFJ \$110,000

S and HH 75,000

Education credits

Qualified education expenses (tuition and fees) incurred by taxpayer, taxpayer's spouse, or taxpayer's dependents

1. Hope Scholarship Credit Maximum is \$1,500/student/year
 - a. 100% of first \$1,000 tuition expenses
50% of next \$1,000
 - b. Only applies to first two years of post-secondary education
 - c. Credit is available per eligible student
2. Lifetime Learning Credit for part-time or full-time undergraduate, graduate, or professional degree programs
 - a. Based on 20% of qualified expenses up to \$10,000 per year, so $\$10,000 \times .2 = \$2,000$ max
 - b. Usually taken when Hope is not
 - c. Usually used for individuals beyond year 2 of education

Both credits are available for the taxpayer, taxpayer's spouse, or the taxpayer's dependents.

Individuals cannot claim both a deduction and a credit for the same qualifying tuition expenses, and both credits are phased out for high-income taxpayers.

MFJ - \$85,000- 105,000 AGI

S - \$42,000-52,000.

Taxpayer can waive Hope and Lifetime Learning Credits

Earned income credit- to offset impact of payroll tax on low-income workers. This is a refundable credit even if you have no tax liability

The amount of credit depends on the taxpayer's earned income and phases out after the taxpayer's income reaches a certain level. At EI of \$34,000, the EIC is 0.

Another factor is the number of children living in the home.

Table- Amount of credit is based on the greater of taxpayer's EI or AGI.

Let's go to the table.

Dependent care credit

If maintain a home for a dependent under 13 or someone who is physically or mentally incapable of self care

Allows you to take a credit for some of the cost of having this person taken care of while you are gainfully employed.

Rate x Base

Rate ranges from 20-35%

The base is \$4000 for one child

\$6000 for two or more

Or earned income if lower. What is earned income?

The credit % is 35% for TPs whose AGI does not exceed \$15,000. The rate is gradually reduced to 20% at the rate of 1% for each \$2000 (or fraction thereof) that AGI exceeds \$15,000. TPs with AGI exceeding \$43,000 are allowed a credit of only 20% of qualifying expenses.

Retirement contributions by low-income wage earners

To encourage saving for retirement

Excess payroll tax withholding

6.2 x \$87,900

No affect on business that paid you

8. Alternative minimum tax applies to individuals and C corporations

- a. AMT was specified by Congress – tax preference items are certain items of income or deduction that get special tax treatment
- b. A large number of corporations and individuals with large economic income were paying little or no tax.
- c. AMT is a separate parallel tax system.
Many tax preference items are not allowed or amount of tax relief is reduced.
- d. Taxpayer must pay higher of regular or AMT.
- e. Purpose is to ensure that taxpayers pay a certain minimum amount of tax.
Top rate for individual is 28%
- f. The characteristics most likely to cause AMT liability for individuals include the following:
 - Nontaxable interest income from private activity bonds
 - Numerous personal and dependency exemptions
 - Unusually large medical expenses
 - Large amounts of state and local taxes and miscellaneous itemized deductions
 - The bargain element of incentive stock options
- g. Taxable income
 - Plus/minus adjustments to TI
 - Plus: Tax preferences
 - Minus: Allowable exemption
 - Equals: Alternative Minimum Taxable Income (AMTI)
 - Times: AMT tax rates
 - Equals: Tentative Minimum Tax (TMT)
 - Less: Regular income tax
 - Equals: AMT
- h. Exemption may be phased out Table 11.5
- i. Table 11.6 gives us an idea as to what some of the adjustments are

9. Payment of income tax

Income tax prepayments include withholding and estimated payments.

Estimated payments are made on income items on which there is no withholding, i.e. self-employment income.

Quarterly payments for 2004 are due April 15, June 15, September 15, 2004 and January 15, 2005.

If total payments are less than 90% of the tax liability, a penalty may be imposed on the shortfall.

This penalty is not imposed if the shortfall is less than \$1000.

The penalty is not assessed if the tax prepayment is equal to at least 100% of the previous year's tax liability if AGI is \$150,000 or less, or 110% if AGI is over \$150,000.

10. Who must file

If GI exceeds the sum of the applicable standard deduction and personal exemption(s), you must file a tax return.

You must file a return to receive a refund.

Four principal exceptions to the GI threshold are:

Self-employed folks must file a tax return, regardless of GI, if their net earnings from SE exceed \$400.

TPs 65 or older may add the additional standard deduction for age in determining GI filing requirements.

The GI threshold for children, who are claimed as dependents on their parents' tax return, is the greater of \$800 or their earned income plus \$250.

MFS must file a return if GI equals or exceeds their personal exemption.