Chapter 2

Tax Determination; Personal and Dependency Exemptions; An Overview of Property Transactions

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Tax Formula

Income (broadly conceived) $x,xxx
Less: Exclusions (x,xxx)
Gross Income $x,xxx
Less: Deductions for AGI (x,xxx)
AGI $x,xxx
Less: The greater of-
  Total itemized deductions (x,xxx)
  or the standard deduction (x,xxx)
  Personal & dependency exemptions (x,xxx)
Taxable Income $x,xxx
Standard Deduction
(slide 1 of 2)

- The basic standard deduction (BSD) amount depends on filing status of taxpayer

<table>
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<th>Filing status</th>
<th>2002</th>
<th>2003</th>
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<tbody>
<tr>
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<td>$4,700</td>
<td>$4,750</td>
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<tr>
<td>MFJ, SS</td>
<td>7,850</td>
<td>7,950</td>
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<tr>
<td>HH</td>
<td>6,900</td>
<td>7,000</td>
</tr>
<tr>
<td>MFS</td>
<td>3,925</td>
<td>3,975</td>
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</table>
Standard Deduction
(slide 2 of 2)

- Additional standard deduction (ASD)
  - For taxpayers age 65 or older and/or legally blind

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$1,150</td>
<td>$1,150</td>
</tr>
<tr>
<td>MFJ, SS</td>
<td>900</td>
<td>950</td>
</tr>
<tr>
<td>HH</td>
<td>1,150</td>
<td>1,150</td>
</tr>
<tr>
<td>MFS</td>
<td>900</td>
<td>950</td>
</tr>
</tbody>
</table>
Determining Standard Deduction

• Examples (2003 tax year):
  – Taxpayer is single, blind, and age 65 or older
    • SD = $4,750 (BSD) + $1,150 (ASD) + $1,150 (ASD) = $7,050
  – Taxpayers are married, filing jointly, one blind, and both age 65 or older
    • SD = $7,950 (BSD) + $950 (ASD) + $950 (ASD) + $950 (ASD) = $10,800
Taxpayers Ineligible For Standard Deduction

• Certain taxpayers cannot use the SD:
  – Married, filing separately, when either spouse itemizes deductions
  – Nonresident aliens
  – Individual filing return for tax year of less than 12 months because of change in annual accounting period
SD Limit For Person Claimed as Dependent

• Individual claimed as dependent has a BSD limited to the greater of:
  – $750 or
  – $250 plus earned income (but not exceeding normal BSD)

• ASD amount(s) still available
Examples of SD Limit (slide 1 of 2)

- Dependent’s SD (2003 tax year):
  - A blind child who earns $200 and is claimed by parents as a dependency exemption
    - SD = $750 (BSD) + $1,150 (ASD) = $1,900
  - A child who earns $1,500 and is claimed by parents as a dependency exemption
    - SD = $1,750 [BSD equal to greater of $750 or ($250 + $1,500 earned income)]
Examples of SD Limit (slide 2 of 2)

• Examples of dependent’s SD (2003 tax year)
  – A child who earns $4,800 and is claimed by parents as a dependency exemption
  • SD = $4,750 [BSD limited to normal amount]
Personal and Dependency Exemption Amounts

- **Amounts**
  - 2002: $3,000 per exemption
  - 2003: $3,050 per exemption

- **Personal exemption**
  - One per taxpayer (two personal exemptions when married, filing jointly)
    - Exception: Individual claimed as dependent by another taxpayer does not receive a personal exemption
Personal and Dependency Exemptions In Year Of Death

• Personal exemption allowed on joint return for spouse who dies during the year
  – Example: Tom and Betty were married in 1990. Tom dies on February 1, 2003. A personal exemption may be claimed for Tom on the taxpayers’ 2003 joint return.
Personal and Dependency Exemption Tests

• A dependency exemption may be claimed for each individual that meets all of the following tests:
  – Support
  – Relationship (or household member)
  – Gross income
  – Joint return
  – Citizen or residency
Support Test

• Taxpayer must provide more than 50% of the dependent’s support
  – Only amounts expended are considered in the support test
  – Scholarships of children are not considered in the support test

• Two exceptions to support test requirement:
  – Multiple support agreements
  – Children of divorced parents
Multiple Support Agreements

- Allows group providing > half support to claim individual even though no one person provides > 50% support
  - Eligible parties must provide > 10% of support
  - Each eligible party must meet all other dependency requirements
- Example - Allows children of elderly parent to claim exemption for parent when none individually meets the 50% support test
Children of Divorced Parents

- For post 1984 divorce decrees, custodial parent gets exemption for children
- Noncustodial parent may claim exemption for children if custodial parent signs a Release of Claim to Exemption, Form 8332
Relationship Test

- Dependent must be one of the specified relatives of the taxpayer (either taxpayer, if joint return) or be a member of the taxpayer’s household for the entire year.

- Once a relationship is established by marriage, it continues even if there is a change in marital status.
Gross Income Test

- Dependent’s gross income cannot be greater than amount allowed for an exemption ($3,050 for 2003)
  - Exception: No gross income limitation if dependent is child of taxpayer AND either:
    - i) Less than age 19, OR
    - ii) Less than age 24 and a full-time student
Example of Gross Income Test (slide 1 of 2)

- Grandparent (age 70) meets all dependency tests except has gross income of $3,500
  - Grandparent fails gross income test and cannot be claimed by taxpayer as dependency exemption
Example of Gross Income Test (slide 2 of 2)

- Child (age 16) meets all dependency tests for taxpayer except has gross income of $4,000
  - Gross income exception for child applies and taxpayer can claim child as dependency exemption
Joint Return Test

- Dependent cannot file a joint return with spouse unless:
  - Filing solely for refund of all taxes withheld
  - No tax liability exists for either spouse
  - Neither spouse required to file return
Citizen or Residency Test

• Dependent must be a U.S. citizen or a resident of U.S., Canada, or Mexico
Phase-out of Exemptions  (slide 1 of 2)

Applies when taxpayer’s AGI in 2003 exceeds:

- $209,250 for married, filing jointly, or surviving spouse
- $174,400 for head of household
- $139,500 for single
- $104,625 for married, filing separately
Phase-out of Exemptions (slide 2 of 2)

- Exemptions deduction is reduced by 2% for every $2,500 ($1,250 for MFS), or part thereof, that AGI exceeds threshold amounts.
Child Tax Credit

• $600 tax credit is allowed for each dependent child under the age of 17
  – Qualifying child includes stepchildren and eligible foster children

• Phased out as income exceeds $110,000 ($75,000 for Head of Household and Single filing status)
Taxes Rates (slide 1 of 3)

- Prior to the Tax Relief Reconciliation Act of 2001, tax rates were 15%, 28%, 31%, 36%, and 39.6%.
  - Tax rate brackets are inflation adjusted yearly.
- Maximum rate for long-term capital gains is 20%.
• Under Tax Relief Reconciliation Act of 2001:
  – New 10% bracket is created
  – Rates above 15% are to be reduced each year during phase-in period from 2001 to 2006
  – In 2006, rates will be 10%, 15%, 25%, 28%, 33%, and 35%
Taxes Rates (slide 3 of 3)

- For 2002, tax rates are:
  - 10%, 15%, 27%, 30%, 35%, and 38.6%
Kiddie Tax (slide 1 of 4)

• Net unearned income (NUI) of child is taxed at parents’ rate
  – Child must be under age 14 at end of year
  – NUI generally equals unearned income less $1,500 (2003 tax year)
Kiddie Tax (slide 2 of 4)

- Unearned income includes taxable interest, dividends, capital gains, rents, royalties, pension and annuity income, and unearned income from trusts
• Computing NUI for Kiddie Tax:
  Unearned income
  Less: $750
  Less: The greater of:
    i) $750, or
    ii) Allowable itemized deductions connected with production of unearned income
  Equals: net unearned income
Kiddie Tax (slide 4 of 4)

• Net unearned income taxed at parents’ rate
  – Remainder of taxable income taxed at child’s rate
• Use Form 8615 to compute tax
• An election is available to report the child’s income on parents’ return
Filing Requirements (slide 1 of 2)

• General Rule: Tax return must be filed if gross income is $\geq$ the sum of the standard deduction and exemption amount
  • ASD for blind does not apply for this determination
    – Special rules apply for dependents and self-employed taxpayers
• Tax return of an individual is due on or before the 15th day of the 4th month after taxpayer’s year end
  • Most individuals are calendar year taxpayers, thus, due date is April 15
  • May obtain an extension of time to file
Filing Status

• There are 5 filing statuses
  – Single
  – Married, filing jointly
  – Surviving spouse (qualifying widow or widower)
  – Head of household
  – Married, filing separately

• Filing status affects tax rate brackets, standard deduction, and other amounts
Single Filing Status

- Unmarried individual
- Residual category (i.e., does not qualify for any of the other filing statuses)
Married Filing Jointly (MFJ) Filing Status

- Married as of last day of taxable year, or
- Spouse dies during taxable year
Surviving Spouse Filing Status

- Same tax rate brackets as married, filing jointly
- File as surviving spouse for 2 years after death of spouse if taxpayer maintains a home in which a dependent child lives
Married Filing Separately Filing Status

- Married but not filing a return with spouse and not abandoned spouse
Head of Household (HH) Filing Status

- Must be unmarried as of end of year or an abandoned spouse
- Must pay > half the cost of maintaining a household which is the principal home of a dependent relative for more than half of tax year
2 Exceptions to the HH Requirements

1. HH may be claimed if taxpayer maintains a separate home for his or her parents if at least one parent qualifies as a dependent.

2. If the qualifying individual is an unmarried child or grandchild, the child or grandchild need not be taxpayer’s dependent.
Abandoned Spouse

- Allows married taxpayer to file as Head of Household if taxpayer:
  - Does not file a joint return
  - Paid > half the cost of maintaining a home
  - Spouse did not live in home for last 6 months of tax year
  - Home was principal residence of taxpayer’s child for > half of year
  - Can claim child as a dependent
Gains and Losses from Property Transactions (slide 1 of 3)

• In order for gains (losses) to be recognized (included in gross income), they must be realized:
  – Realized gain (loss) = amount realized - adjusted basis
    • Amount realized = selling price - costs of disposition
    • Adjusted basis = cost + capital additions - cost recovery
• All realized gains are recognized unless a specific tax provision provides otherwise (e.g., nontaxable exchanges)

• Realized losses may or may not be recognized depending on the circumstances
  – Generally, losses on the sale or disposition of personal use property are not recognized
Gains and Losses from Property Transactions (slide 3 of 3)

- Once recognized gains or losses have been determined, they must be classified as ordinary or capital
  - Ordinary gains are fully taxable
  - Ordinary losses are fully deductible
- Capital gains and losses are subject to special tax treatment
Gains and Losses from Capital Asset Transactions (slide 1 of 2)

- Capital assets are defined as any property other than:
  - Inventory,
  - Accounts Receivable, and
  - Depreciable property or real property used in a business

- Most personal use assets owned by individuals are capital assets
  - Losses on these assets are not deductible
Gains and Losses from Capital Asset Transactions (slide 2 of 2)

• Gains and losses from capital asset transactions must be netted
  – Net gains and losses by holding period
  – If excess losses result, they are shifted to the category carrying the highest tax rate
## Max Tax Rates for Net Capital Gains of Individuals

<table>
<thead>
<tr>
<th>Classification</th>
<th>Maximum Rate</th>
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<tbody>
<tr>
<td>Short-term gains (held ≤ one year)</td>
<td>38.6%</td>
</tr>
<tr>
<td>Long-term gains (held &gt; one year)</td>
<td></td>
</tr>
<tr>
<td>• Collectibles</td>
<td>28%</td>
</tr>
<tr>
<td>• Certain depreciable property used</td>
<td></td>
</tr>
<tr>
<td>in a trade or business (unrecaptured § 1250 gain)</td>
<td>25%</td>
</tr>
<tr>
<td>• All other long-term capital gains</td>
<td>20% or 10%</td>
</tr>
</tbody>
</table>
Treatment of Capital Losses

- Net capital losses of individuals are deductible FOR AGI up to $3,000 yearly
  - Excess capital losses are carried over to the next tax year
  - When carried over, capital losses retain their classification as short- or long-term
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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