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	
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

Filing status	2002	2003
Single	$4,700	$4,750
MFJ, SS	7,850	7,950
HH	6,900	7,000
MFS	3,925	3,975

Standard Deduction
(slide 2 of 2)

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

Filing Status	2002	2003
Single	$1,150	$1,150
MFJ, SS	900	950
HH	1,150	1,150
MFS	900	950

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
- $174,4000 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%

Taxes Rates (slide 2 of 3)

- 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

Kiddie Tax (slide 3 of 4)

- 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

Filing Requirements (slide 2 of 2)

- 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

Gains and Losses from Property Transactions (slide 2 of 3)

- 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

Classification	Maximum Rate
Short-term gains (held ≤ one year)	38.6%
Long-term gains (held > one year)	
• Collectibles	28%
• Certain depreciable property used in a trade or business (unrecaptured § 1250 gain)	25%
• All other long-term capital gains	20% or 10%

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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