

Determination of Income Tax Liability

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Learning Objectives

An understanding of the material in this chapter should enable you to

- 4-1. Explain the concept of adjusted gross income.
- 4-2. Explain the determination of taxable income.
- 4-3. Explain how tax liability is determined.
- 4-4. Explain what is meant by the kiddie tax.
- 4-5. Explain the due dates for filing income tax returns.

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The Higher the Tax Bracket, the Better the View.

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INTRODUCTION

Objective 4-1

This chapter will examine the basic steps in determining an individual's income tax liability. It begins with a discussion of how an individual's adjusted gross income is determined using gross income as a starting point. Then the determination of taxable income is examined, followed by the calculation of actual tax payable.

In the course of following this process, several fundamental tax rules applicable to individuals will be covered including the general concepts of exclusions and deductions, the standard deduction, personal and dependency exemptions, filing status, tax rates, and the "kiddie tax."

THE DETERMINATION OF ADJUSTED GROSS INCOME

The Nature of Exclusions

The concept of gross income was discussed in chapter 3. Gross income is essentially all income that a taxpayer realizes during the tax year minus any available exclusions from gross income.

In chapters 5 and 6, various items that are includible or partially includible in gross income will be examined. Items of income that are excludible from a taxpayer's gross income will also be discussed. An exclusion may be defined as an item of income that is not required to be included in gross income pursuant to a specific provision of the income tax law. It is something quite different from a deduction. A deduction is an expense paid or incurred by a taxpayer that the tax law specifically allows to be subtracted from the amount of income that is otherwise subject to tax. It is an item of expense. An exclusion, on the other hand, is an item of income that may be received by a taxpayer without being included in gross income.

As previously stated, a taxpayer's gross income equals all items of income received by the taxpayer during the year minus all available exclusions from gross income.

Once gross income has been determined, the next step is to reduce gross income by all deductions that are allowable in determining adjusted gross income.

What Is Adjusted Gross Income?

**adjusted gross
income (AGI)**

The calculation of an individual taxpayer's *adjusted gross income (AGI)* is an intermediate step in the process of calculating taxable income. To calculate adjusted gross income, certain deductions are subtracted from the individual's gross income.

**above-the-line
deductions
below-the-line
deductions**

There are two fundamental categories of deductions for individual taxpayers: deductions allowable in determining adjusted gross income and deductions allowable in determining taxable income. Deductions subtracted from gross income in determining adjusted gross income are referred to as *above-the-line deductions*. Deductions subtracted from adjusted gross income in determining taxable income are referred to as *below-the-line deductions*.

Although the calculation of AGI is an intermediate step, it is an important one. Two of the most significant reasons why are as follows:

- Above-the-line deductions allowable in determining adjusted gross income are available regardless of whether the taxpayer claims "itemized" deductions. As explained below, the taxpayer claims itemized or below-the-line deductions only if the total of such deductions exceeds the available standard deduction. For this reason, above-the-line deductions are often more valuable to the taxpayer.
- Many tax benefits, including the availability of several deductions and the amount of the taxpayer's personal and dependency exemptions, are currently reduced or "phased out" if the taxpayer's AGI exceeds certain specified amounts. Several of these "phaseouts" are discussed in this text. Certain other deductions are available only to the extent that the amount of such deductions exceeds a specified percentage of AGI (a deduction "floor"). Also the deduction for charitable contributions is allowed only to the extent that contributions do not exceed a specified percentage of AGI (a deduction "ceiling").

The reduction of an individual's AGI results in the increased availability of other tax benefits. In fact, the maximum allowable reduction of an individual's AGI is one of the most important individual tax planning objectives. Above-the-line deductions reduce AGI, while below-the-line deductions do not.

With a few exceptions, above-the-line deductions generally relate to business or income-producing activities of the taxpayer. On the other hand, the majority of the taxpayer's itemized or below-the-line deductions are expenses or losses of a personal nature for which Congress has provided income tax deductions for social and economic policy reasons.

Deductions Allowable in Determining Adjusted Gross Income

The following expenses are some of the more important deductions that are claimed above-the-line by individual taxpayers. This list is not all-inclusive.

- all deductions attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee
- certain business expenses of employees, including expenses reimbursed by the taxpayer's employer, business expenses of performing artists, and business expenses of certain public officials
- losses from the sale or exchange of property (Property sales will be discussed in later chapters of this text.)
- deductions attributable to rents and royalties
- deductible contributions to pension and profit-sharing plans of self-employed individuals
- deductible contributions to IRAs
- penalties or other forfeitures resulting from premature withdrawals from time savings accounts or deposits (including certificates of deposit)
- deductible alimony payments
- the portion of jury duty pay remitted to the taxpayer's employer
- deductions for clean-fuel vehicles and certain refueling property
- deductible moving expenses
- contributions to medical savings accounts or health savings accounts
- deductible interest payments made on qualified education loans
- deductible higher education expenses
- the deduction for legal costs paid in connection with certain civil rights actions

THE DETERMINATION OF TAXABLE INCOME

Objective 4-2

taxable income

Introduction

An individual's *taxable income* is determined by subtracting the following items from adjusted gross income:

- either the total of the taxpayer's allowable itemized deductions or the taxpayer's applicable standard deduction amount, whichever is greater, and
- the total allowable amount of the taxpayer's personal and dependency exemptions

The amount of the taxpayer's standard deduction is based on filing status. Increased amounts are available for blind taxpayers and taxpayers aged 65 and over. Personal and dependency exemptions are "phased out" for upper income taxpayers as explained below.

The Standard Deduction

The standard deduction is a specified amount, indexed annually for inflation, that may be claimed in calculating taxable income by taxpayers who do not itemize their deductions. As stated above, taxpayers claim itemized deductions if the total amount of such deductions exceeds the available standard deduction. For tax years beginning in 2007 the standard deduction amounts are

Filing Status	Amount
Married filing jointly	\$10,700
Unmarried head of household	7,850
Single	5,350
Married filing separately	5,350

Standard Deduction for Dependents

A special rule applies to taxpayers who are dependents. A dependent is an individual for whom another taxpayer claims a dependency exemption. Dependents are not eligible to claim the regular standard deduction amounts on their own returns. As indexed for inflation for the 2007 tax year, the special standard deduction amount allowable on a dependent's tax return is the greater of:

- a sum equal to the amount of the dependent's earned income for the year plus \$300 (but not more than the regular standard deduction amount), OR
- \$850 (for 2007)

For example, a dependent with earned income of \$1,000 would be entitled to a standard deduction of \$1,300 (\$1,000 plus \$300). A dependent with earned income of \$400 in 2007 would be entitled to a standard deduction of \$850 because that amount is greater than his or her earned income plus \$300 (\$700).

Aged or Blind Taxpayers

Another special rule applies to taxpayers who are 65 years of age or older and/or are legally blind. Such taxpayers (including dependents) are entitled to increase their standard deduction by specified amounts. For married taxpayers filing jointly, each spouse who qualifies may add the additional amount or amounts to the standard deduction claimed on the joint return. As indexed for inflation for the 2007 tax year, these "additional amounts" are as follows:

- \$1,300 for taxpayers who are unmarried and are not filing as surviving spouses using tax rates applicable to joint returns
- \$1,050 for other taxpayers

Example: Mr. and Mrs. Volare file a joint return for 2007. Mr. Volare is 64 years old, and Mrs. Volare is 67. Their standard deduction amount is \$11,750, the sum of the regular amount of \$10,700 plus the applicable additional amount of \$1,050. Mr. and Mrs. Volare will claim the standard deduction in calculating their taxable income unless the total of their itemized deductions exceeds \$11,750. If so, they will itemize their deductions and not claim the standard deduction.

The Overall Limitation on Itemized Deductions

The rules applicable to specific itemized deductions will be discussed in chapter 9. However, in discussing the process of calculating individual income tax liability, it is important to consider the "overall limitation" on itemized deductions. This rule is one of the many "phaseout" provisions in

the Internal Revenue Code that reduce or eliminate tax benefits for taxpayers with income above certain levels in a given year.

If an individual taxpayer's adjusted gross income exceeds a specified threshold amount that is indexed annually for inflation, the taxpayer's itemized deductions are reduced by 3 percent of the amount by which AGI exceeds the threshold amount. For 2007, that specified amount is \$156,400 (\$78,200 or half of the regular amount for married taxpayers filing separately). If itemized deductions are reduced by the overall limitation, the reduction cannot exceed 80 percent of the total itemized deductions that are subject to the reduction. However, the overall limitation does not apply to deductions for medical expenses, investment interest expenses, casualty and theft losses, or allowable gambling losses.

For 2006 and 2007, only two-thirds of the reduction determined under this calculation is applied to the taxpayer.

Example:

Mark and Terry Sellers are married taxpayers filing jointly. For 2007, their adjusted gross income is \$265,000. Mark and Terry have the following itemized deductions: \$25,000 for state and local taxes, \$18,000 of deductible interest on a home mortgage, and a deductible casualty loss from uninsured flood damage of \$40,000 (after all the specific restrictions on the deduction for personal casualty losses have been applied). Their AGI exceeds the threshold amount of \$156,400 by \$108,600 (\$265,000 – \$156,400). Three percent of that amount is \$3,258 (\$108,600 x .03). The couple's state and local taxes and their home mortgage interest are subject to the overall limitation, but their deductible casualty loss is not. Therefore the total amount subject to the limit is \$43,000 (\$25,000 + \$18,000).

Of that \$43,000, Mark and Terry will lose two-thirds of the \$3,258 amount, or \$2,173. The \$3,258 amount is multiplied by two-thirds under the provision that lessens the amount of this phaseout for 2007.

The overall limitation on itemized deductions is applied after the rules and limits for each specific itemized deduction have been applied. These specific rules include the 50 percent of AGI "ceiling" on charitable contributions, the dollar amount loan limits for qualified residence interest,

and the 2 percent of AGI “floor” on most miscellaneous itemized deductions. All of these topics are covered in detail in later chapters of this text.

For 2008 and 2009, only one-third of the reduction determined under this calculation will be applied to the taxpayer. In this manner, the overall limitation on itemized deductions has gradually been reduced since 2006 and is scheduled to be completely eliminated by 2010.

Personal and Dependency Exemptions

Introduction

In the computation of taxable income, taxpayers are permitted to subtract from AGI the total amount of their allowable personal and dependency exemptions. Each exemption is the equivalent of a deduction for a specified amount that is indexed annually for inflation. This amount is referred to as an “exemption” rather than as a “deduction” because it is not attributable to any actual or determinable expense made by the taxpayer. Rather, it is an arbitrary amount that is granted to taxpayers under the tax law to help reduce the net cost of their personal expenses. Personal and dependency exemptions are allowable regardless of whether the taxpayer claims the standard deduction or itemizes deductions.

These exemptions are available in two forms: personal exemptions and dependency exemptions. The amount is the same for each type of exemption. For the year 2007, the exemption amount is \$3,400. For each individual with respect to whom either a personal or dependency exemption is claimed on a tax return, a taxpayer identification number (Social Security number) must be included on the return.

Personal Exemptions

Each taxpayer is generally permitted to claim one personal exemption for himself or herself on the individual tax return. Married taxpayers filing jointly are allowed one personal exemption for each spouse. If married taxpayers file a separate return, generally only one exemption is allowed. However, if the spouse of the taxpayer filing the separate return has no gross income and is not the dependent of another taxpayer, an exemption for that spouse is allowed.

A special rule applies to individuals with respect to whom a dependency exemption is claimed by another taxpayer. Taxpayers who are “dependents” in this sense are not permitted to claim their own personal exemption on their individual returns. In this way, a total of only one exemption is claimed for each person. The rules for dependency exemptions are discussed below.

Dependency Exemptions

Taxpayers are entitled to claim one additional exemption for each individual who is a dependent of the taxpayer.

Currently, an individual is eligible to be claimed as a dependent of a taxpayer if that individual is either a “qualifying child” or a “qualifying relative” of the taxpayer. Following are definitions for those terms.

“Qualifying Child” Definition. The definition of a “qualifying child” has four basic elements.

First, the individual must bear a relationship to the taxpayer that meets ONE of the following three descriptions:

- a child of the taxpayer or descendant of such child. A “child” for this purpose includes a son, daughter, stepson, or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer. Relationship by adoption is treated the same as relationship by blood.
- a descendant of any individual who meets the definition of a “child,”
OR
- a brother, sister, stepbrother, or stepsister of the taxpayer, or a descendant of any such person

Second, the individual must have the same principal place of abode as the taxpayer for more than half of the taxable year. Temporary absences due to special circumstances (such as illness, education, vacation, or military service) will not be treated as absences for purposes of this rule.

Third, the individual must meet ONE of the following three requirements:

- The individual must be under the age of 19 at the end of the year.
- The individual must be a student under the age of 24 at the end of the year (a “student” for this purpose is an individual who is a full-time student during each of five calendar months during the year), OR
- The individual must be totally and permanently disabled at any time during the year.

Fourth, the individual must NOT have provided more than half of his or her own support during the year.

“Qualifying Relative” Definition. There are four basic requirements that an individual must meet to be treated as a “qualifying relative.” These are as follows:

First, the individual must not be a “qualifying child” of any taxpayer for the year. This, in effect, makes the definitions of “qualifying child” and “qualifying relative” mutually exclusive. However, under certain circumstances a son or daughter of the taxpayer who is not a “qualifying child” may meet the tests for a “qualifying relative.”

Second, the individual must meet ONE of the following two requirements:

- He or she must bear a specified relationship to the taxpayer. Specified relationships include a child of the taxpayer; a descendant of such child; a brother, sister, stepbrother, stepsister, father, or mother; an ancestor of a father or mother; a stepfather or stepmother; a nephew or niece; an uncle or aunt; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- He or she must be an individual (other than the taxpayer’s spouse) whose principal place of abode during the tax year was the home of the taxpayer and who is a member of the taxpayer’s household. This rule does not require that the individual be related to the taxpayer, and may include a domestic partner of the taxpayer, so long as the relationship between the taxpayer and the individual does not violate local law. Note that the taxpayer’s spouse cannot be a qualifying relative.

Third, the individual’s gross income for the year must be less than the “exemption amount” (\$3,400 for 2007, as indexed for inflation).

Fourth, the taxpayer must provide over one-half of the individual’s support for the year. The term “support” for purposes of the dependency exemption rules generally means expenses for the necessities of life and other important expenses, such as those for education and activities of the individual. However, certain scholarships granted to full-time students are not included in the calculation of support.

Additional Requirements. For an individual who meets either the definition of a “qualifying child” or a “qualifying relative,” there are three more rules that must be met in order for him or her to be claimed as a dependent. These are as follows:

First, the individual being claimed as a dependent may not claim any other individual as his or her own dependent for income tax purposes.

Second, the individual being claimed as a dependent may not file a joint return with his or her spouse for the year (unless the individual and his or her

spouse are not required to file a return and the only purpose for filing is to obtain a refund of tax withheld).

Third, an individual who is not a U.S. citizen or national cannot be claimed as a dependent unless that individual is a resident of either the United States or a country contiguous to the United States. However, a legally adopted child of the taxpayer (or one legally placed for adoption) can be claimed as a dependent of the taxpayer if the child has the same principal place of abode as the taxpayer for the year and is a member of the taxpayer's household (provided that the taxpayer is a U.S. citizen or national).

“Tie-Breakers” to Determine Who Gets the Exemption. The rules can result in situations where more than one taxpayer is able to claim an individual as a dependent. So, the law provides tiebreaking rules. First, if only one of the taxpayers eligible to claim an individual as a dependent is a parent of that individual, the parent is entitled to the exemption. This can occur, for example, where both a grandparent and a parent are eligible. Second, if a child's parents don't file a joint return, and each of them is eligible to claim the child as a dependent, the parent with whom the child resided for the longer period of time during the year gets the exemption. If that amount of time is equal, then the parent with the greater amount of AGI for the year gets the exemption. Third, if the child or other individual is not claimed as a dependent by either of his or her parents, and other taxpayers are able to claim the individual as a dependent, then the taxpayer with the highest AGI for the year gets the exemption. Note that these rules will apply where more than one taxpayer attempts to claim an exemption for the same person. Eligible taxpayers are generally free to agree among themselves who will claim a dependency exemption for an individual who can be claimed by more than one taxpayer.

“Phaseout” Rule for Personal and Dependency Exemptions

Another “phaseout” provision applies to the personal and dependency exemptions of upper-income taxpayers. The dollar amount of each available exemption is phased out in increments of 2 percent of the exemption amount for taxpayers with income above specified threshold levels. All the taxpayer's personal and dependency exemptions are phased out simultaneously, rather than sequentially or “one by one.” The threshold income levels for the phaseout are based on adjusted gross income, are indexed annually for inflation, and vary according to the filing status of the taxpayer.

The AGI amounts at which the phaseout begins and at which the phaseout is maximized are as follows for 2007:

Filing Status	AGI Threshold Phaseout Amount	AGI Amount at Which Phaseout Is Maximized
Married filing jointly	\$234,600	\$357,101
Head of household	195,500	318,001
Single	156,400	278,901
Married filing separately	117,300	178,551

Each personal and dependency exemption otherwise allowable to a taxpayer is phased out by 2 percent of each \$2,500 or any fraction of \$2,500 by which AGI is in excess of the threshold phaseout amount. The term “any fraction of \$2,500” essentially means that the first dollar of each \$2,500 increment of AGI above the threshold phaseout amount results in the loss of 2 percent of the exemption amount. For example, a taxpayer with AGI of \$2,501 above the threshold amount would lose 4 percent of the exemption amount for all personal and dependency exemptions.

For 2006 and 2007, the percentage of the exemption amount that is lost by the taxpayer is multiplied by two-thirds. This additional step lessens the detrimental effect of this phaseout.

Example:

Louise and Don McGill are married and file a joint return. This year, their adjusted gross income is \$360,000. Except for their income level, they would be entitled to two personal exemptions on their return. Because of their income level, their exemption amount is phased out by 2 percent for each \$2,500 or fraction thereof by which their AGI exceeds \$234,600. The range of income over which their exemption amount is reduced is \$122,501 (\$357,101 – \$234,600). This amount is equal to \$2,500 x 49, plus \$1 under the fractional rule. The first 49 increments of \$2,500 of AGI over the threshold amount reduce their exemption by 98 percent. The next dollar of income increases the phaseout percentage to 100 percent. Since the McGills’ AGI is in excess of the phaseout completion amount of \$357,101 (their AGI is \$360,000), they have reached the 100 percent phaseout percentage. However, for 2007, the 100 percent is multiplied by two-thirds to lessen the effect of the phaseout. Therefore, their final phaseout percentage is 66.7 percent. As a result, their 2007 personal exemption amounts of \$3,400 each are reduced by 66.7 percent. Therefore, the amount of their personal exemptions that is phased out is \$2,268

(\$3,400 x .667). This leaves each of them with an allowable personal exemption of \$1,132 (\$3,400 – \$2,268).

For 2008 and 2009, the percentage of the exemption amount that is lost by the taxpayer is multiplied by one-third to calculate the amount phased out. In this manner, the phaseout rule for personal and dependency exemptions has been gradually reduced since 2006 and is scheduled to be completely eliminated by 2010.

Other Phaseout Rules

Phaseout rules essentially increase the effective rate of income tax on upper-income taxpayers. Many taxpayers are subject to more than one phaseout. For example, the same taxpayer can currently be subject to both the phaseout of the exemption amount and the overall limitation on itemized deductions. Such combinations of the loss of tax benefits results in additional increments of the taxpayer's income being taxed at effective rates higher than the marginal rate of tax imposed by the Internal Revenue Code, so long as the taxpayer's income is still within the ranges of income at which tax benefits are being phased out.

In addition to the marginal rate of tax imposed by the rate system as discussed below, taxpayers are also losing deductions (and/or credits) with each additional increment of income that results in phaseouts. Therefore the actual effective tax rate on the increments of income that result in the phaseout of tax benefits may be significantly higher than the statutory marginal rate.

Phaseouts have become widespread in the tax law. Many of them will be covered in later chapters of this text. Some of the other tax benefits that are subject to variations of the phaseout concept include the following:

- tax credit for children
- tax credits for higher education
- deductible IRA contributions
- tax credit for adoption expenses
- “active participation” exception to the passive loss rules
- exclusion for certain income from U.S. savings bonds used for higher education
- deduction for interest on qualified higher education loans
- tax credit for child-care expenses
- earned income credit

The above list, although not all inclusive, is indicative of how Congress has become enamored of the phaseout concept in the income tax law.

Divorced or Separated Parents

The general rule for claiming a dependency exemption for a child of divorced or separated parents is that the custodial parent is entitled to the dependency exemption. However, if the custodial parent signs a written declaration that he or she will not claim the child as a dependent for tax purposes (that is, “releases” the exemption), the noncustodial parent may claim the exemption if the written declaration is attached to his or her tax return. A “custodial parent” for this purpose is the parent who has custody of the child for the greater portion of the calendar year. This rule applies regardless of the general requirement that a “qualifying child” have the same principal place of abode as the taxpayer.

Multiple Support Agreements

There is a special rule for certain situations in which no one individual provides over half of a qualifying relative’s support. The most common example of such a situation is probably where siblings provide combined support to an elderly parent. Normally, each individual providing support would be entitled to claim the dependent for tax purposes, except that the “more than half” support test is not met by any one individual providing support. The rule for such cases is that an individual who contributed more than 10 percent of the dependent’s support for the year and who is entitled to claim the exemption except for the support test may claim the dependency exemption. However, every other individual who provided more than 10 percent of the dependent’s support (and is also eligible to claim the exemption except for the support test) must file a written declaration with the IRS stating that he or she will not claim the dependency exemption.

TAX RATES AND FILING STATUS

Objective 4-3

Tax Rates and Brackets

Once taxable income has been determined, tax rates are applied to determine the individual’s tentative income tax liability. That liability may then be reduced by any tax credits for which the taxpayer is eligible. For taxpayers other than corporations, there are five sets of tax rates that differ according to the taxpayer’s filing status. For individuals, each filing status or set of rates includes different amounts of taxable income that are subject to each of the six basic federal income tax rates under current law. The lowest

tax rates are 10 and 15 percent. Under current law, the four other rates are 25, 28, 33, and 35 percent.

The filing status for taxpayers other than corporations includes the following five groups:

- married taxpayers filing jointly
- unmarried heads of households
- unmarried or “single” taxpayers
- married taxpayers filing separately
- estates and trusts

The amount of taxable income subject to each tax rate for each filing status can be referred to as a tax “bracket.” These brackets are indexed annually for inflation. For 2007, the tax brackets (also referred to as “tax rate schedules”) for each filing status are shown in table 4-1.

Example:

Garry and Karen are married taxpayers filing jointly. Their taxable income this year is \$199,000. Their tax due is \$44,870, computed as follows:

- Their taxable income up to \$15,650 is taxed at a rate of 10 percent, which equals a tax of \$1,565.
- Their taxable income over \$15,650 but not over \$63,700 (or \$48,050) is taxed at a rate of 15 percent, which equals a tax of \$7,207.
- Their taxable income over \$63,700 but not over \$128,500 (or \$64,800) is taxed at a rate of 25 percent, which equals a tax of \$16,200.
- Their taxable income over \$128,500 but not over \$195,850 (or \$67,350) is taxed at a rate of 28 percent, which equals a tax of \$18,858.
- Their taxable income over \$195,850 but not over \$349,700 (or \$3,150, the remainder of their taxable income) is taxed at a rate of 33 percent, which equals a tax of \$1,040.

The tax computed under each of the brackets shown above is added together for a total of \$44,870 (\$1,565 + \$7,207 + \$16,200 + \$18,858 + \$1,040).

TABLE 4-1
Individual Tax Rate Schedules for 2007

	If taxable income is	The tax is
Married individuals filing joint returns and surviving spouses	Not over \$15,650 Over \$15,650 but not over \$63,700 Over \$63,700 but not over \$128,500 Over \$128,500 but not over \$195,850 Over \$195,850 but not over \$349,700 Over \$349,700	10% of the taxable income \$1,565 plus 15% of the excess over \$15,650 \$8,772.50 plus 25% of the excess over \$63,700 \$24,972.50 plus 28% of the excess over \$128,500 \$43,830.50 plus 33% of the excess over \$195,850 \$94,601 plus 35% of the excess over \$349,700
Heads of households	Not over \$11,200 Over \$11,200 but not over \$42,650 Over \$42,650 but not over \$110,100 Over \$110,100 but not over \$178,350 Over \$178,350 but not over \$349,700 Over \$349,700	10% of the taxable income \$1,120 plus 15% of the excess over \$11,200 \$5,837.50 plus 25% of the excess over \$42,650 \$22,700 plus 28% of the excess over \$110,100 \$41,810 plus 33% of the excess over \$178,350 \$98,355.50 plus 35% of the excess over \$349,700
Unmarried individuals (other than surviving spouse and heads of households)	Not over \$7,825 Over \$7,825 but not over \$31,850 Over \$31,850 but not over \$77,100 Over \$77,100 but not over \$160,850 Over \$160,850 but not over \$349,700 Over \$349,700	10% of the taxable income \$782.50 plus 15% of the excess over \$7,825 \$4,386.25 plus 25% of the excess over \$31,850 \$15,698.75 plus 28% of the excess over \$77,100 \$39,148.75 plus 33% of the excess over \$160,850 \$101,469.25 plus 35% of the excess over \$349,700
Married individuals filing separate returns	Not over \$7,825 Over \$7,825 but not over \$31,850 Over \$31,850 but not over \$64,250 Over \$64,250 but not over \$97,925 Over \$97,925 but not over \$174,850 Over \$174,850	10% of the taxable income \$782.50 plus 15% of the excess over \$7,825 \$4,386.25 plus 25% of the excess over \$31,850 \$12,486.25 plus 28% of the excess over \$64,250 \$21,915.25 plus 33% of the excess over \$97,925 \$47,300.50 plus 35% of the excess over \$174,850
Estates and trusts	Not over \$2,150 Over \$2,150 but not over \$5,000 Over \$5,000 but not over \$7,650 Over \$7,650 but not over \$10,450 Over \$10,450	15% of the taxable income \$322.50 plus 25% of the excess over \$2,150 \$1,035 plus 28% of the excess over \$5,000 \$1,777 plus 33% of the excess over \$7,650 \$2,701 plus 35% of the excess over \$10,450

Note that these tax rate schedules are those which apply to ordinary income and not to capital gains of individual taxpayers. For a detailed discussion of the taxation of capital gains as distinguished from ordinary income, refer to chapter 14. Qualified dividends are also subject to special tax rates as discussed in chapter 19.

Filing Status for Individual Taxpayers

Married Taxpayers Filing Jointly

Taxpayers who are married at the end of the tax year are generally permitted to file a joint return. A joint return may also be filed if one of the spouses dies during the tax year. A taxpayer who qualifies as a “surviving spouse” as discussed below is also eligible to file as a married taxpayer filing jointly. If a couple has obtained a decree of divorce or of separate maintenance, neither partner is eligible to file jointly.

Married couples who file jointly are, as a general rule, jointly and severally liable for the tax due. However, if one of the spouses qualifies as an “innocent spouse” under a special set of rules, that spouse may be relieved of all or a portion of the liability to pay tax arising from the joint return.

Surviving Spouses

A “surviving spouse” is permitted to file and use the tax brackets applicable to joint returns for a period of 2 years beginning with the year following the year of the spouse’s death. In order to qualify, the surviving spouse must maintain as his or her home a household that includes as a member of the household a son, stepson, daughter, or stepdaughter of the surviving spouse who is eligible to be claimed as the surviving spouse’s dependent under the dependency exemption rules. The surviving spouse must furnish over half the cost of maintaining such a household.

Why would a surviving spouse wish to file as a married taxpayer filing jointly? The answer lies in the structure of the tax rate schedules. The tax rate schedules for joint returns produce the lowest tax payable for any one amount of income as compared with any other filing status. This is so because the brackets to which the lower income tax rates apply are larger for joint filers.

Head of Household Filing Status

The rate schedules applicable to an unmarried head of household are more beneficial than those for single taxpayers but not as beneficial as joint return rate schedules. The rules for qualifying as an unmarried head of household are somewhat complicated. These rules can be summarized using four basic components:

- *the marital status requirement.* The taxpayer must be unmarried at the close of the taxable year, unless the taxpayer’s spouse was not a

member of the household for the last 6 months of the tax year and the household includes a child for whom the taxpayer is eligible to claim a dependency exemption (a so-called “abandoned spouse”). Taxpayers who are legally separated under a decree of divorce or separate maintenance (other than an interlocutory decree) are not considered to be married. Taxpayers who qualify as surviving spouses under the rules discussed above will use joint return rate schedules and are not treated as heads of households.

- *the household requirement.* The taxpayer must maintain a household as his or her home and furnish over half the cost of maintaining that household during the taxable year. At least one “qualifying person” must be a member of this household.
- *the “qualifying person” requirement.* A person who qualifies an unmarried taxpayer (who pays more than half the cost of maintaining a household) for head of household filing status may be any ONE of the following:
 - a “qualifying child” of the taxpayer under the dependency exemption rules
 - a “qualifying relative” under the dependency exemption rules, provided that the relative lives in the taxpayer’s household for more than half the year (not always required for dependency exemption purposes) AND provided that the “qualifying relative” is actually related to the taxpayer (i.e., a domestic partner or other unrelated dependent would not suffice), OR
 - a dependent parent not living with the taxpayer, for whom the taxpayer provides more than half the cost of providing a household

A release of the dependency exemption from the custodial parent to the noncustodial parent is ignored for purposes of determining head of household filing status. Adopted children are, of course, treated the same way as biological children.

- *the rule for parents.* A parent may be a “qualifying person,” even if the parent does not live in the taxpayer’s household, if the taxpayer is eligible to claim a dependency exemption for the parent, and the taxpayer furnishes over half the cost of maintaining the parent’s household. This makes it possible for unmarried taxpayers who pay for a parent’s residence in a long-term care facility to be treated as heads of households.

Other Filers

The remaining types of filing status include single taxpayers, married taxpayers filing separately, and estates and trusts. The tax rate schedules

applicable to estates and trusts are the most “compressed”; that is, the highest tax rates take effect at the lowest levels of taxable income for these taxpayers. Single taxpayers use rate schedules that are less compressed than those applicable to both marrieds filing separately and estates and trusts. Corporations are subject to a different tax rate structure as discussed in chapter 18.

TAX CREDITS

After the tax has been computed on taxable income using the applicable filing status, the actual tax liability shown on the return may be reduced if the taxpayer qualifies for credits. Tax credits are dollar-for-dollar reductions in the actual tax owed; deductions, on the other hand, only reduce the amount of income subject to tax. Therefore credits are quite beneficial to taxpayers. Several significant tax credits that may be available to individual taxpayers are discussed in chapter 10.

THE KIDDIE TAX

Objective 4-4

One popular tax planning strategy is the shifting of income to a taxpayer who is subject to a lower marginal rate. Since parents generally have more income than young children, investment assets are often transferred to children by parents in order to gain the benefit of lower marginal tax rates. Custodial accounts or certain trusts can be used for this purpose.

Under current tax law, however, this planning strategy is significantly curtailed. Families are prevented from shifting large amounts of unearned income to children and making the shift effective for income tax purposes. The provision that limits such income shifting is referred to as the *kiddie tax*.

kiddie tax

The mechanics of the kiddie tax are essentially as follows:

- If a child who is under the age of 18 at the end of the tax year has unearned income above a specified amount, the excess is taxed at the highest marginal rate applicable to the child’s parents for the year rather than at the child’s marginal rate. (At the time of this writing in May 2007, the specified age for children subject to the kiddie tax was under 18. However, Congress was considering raising it again, as it did effective in 2006.) The child’s excess unearned income above the specified amount is called “net unearned income.” The specified amount is the amount of a dependent child’s regular standard deduction (\$850 as adjusted for inflation in 2007) plus another \$850, or \$1,700 for 2007. Therefore unearned income in excess of \$1,700 is “net unearned income” and is taxed at the parents’ rates in 2007.

- This prevention of the income-shifting technique generally applies to income generated by any asset the child owns, regardless of whether the asset was received from the child's parents or from another source. It also applies regardless of when any income-producing assets were transferred to the child. If the income is unearned and is included in the child's taxable income, it is subject to these rules. However, an important exception applies to income from certain disability trusts that are qualified under Social Security laws. Income from such trusts is treated as earned income under the kiddie tax rules, so the kiddie tax does not apply to such income.
- The additional tax paid with the child's return is equal to the difference between the tax payable at the child's rates and the amount of tax the parents would have paid on the net unearned income if it had been included on the parents' return. If more than one child in the same family has net unearned income, the total net unearned income is added together to determine the total tax on the income. Then the additional tax payable is allocated to the children's returns on a pro-rata basis. Instead of paying the kiddie tax on the child's return, the parents may elect to include the income of the child on their own return. This election can be made if the child has no income other than dividends and interest, and if such income is more than \$850 and less than \$8,500 (as adjusted for inflation for 2007).
- The kiddie tax applies only if the child has at least one parent living at the end of the taxable year.
- The kiddie tax does not apply if the child is married and files a joint return with his or her spouse.
- The rules become a bit more complicated if a child has both earned and unearned income. Dependent children are entitled to a standard deduction equal to the greater of \$850 in 2007 or the amount of the child's earned income plus \$300, up to the regular standard deduction amount. If a child has both earned and unearned income, up to \$850 of the child's standard deduction is allocated to unearned income first. The next \$850 of unearned income is taxed at the child's marginal rate. Any remaining standard deduction allowable to the child is allocated to the child's earned income.
- If the child's unearned income includes qualified dividends subject to a maximum tax rate of 15 percent as explained in chapter 19, the child will be taxed at the maximum 15 percent rate rather than the lower 5 percent or 0 percent rates if the parents' highest marginal rate on ordinary income exceeds 15 percent.

Example: Kyle Bradford is 10 years old. He lives with his mother, Melody, who is unmarried. This year, he has \$1,000 in earned income from doing work for neighbors, and \$2,000 in interest income from a custodial bank account. Kyle's standard deduction is \$1,300 (\$1,000 of earned income plus \$300). The first \$850 of his standard deduction is allocated to his \$2,000 of unearned income. The remaining \$1,150 of Kyle's unearned income is subject to taxation. Of this amount, \$850 will be taxed at Kyle's marginal rate. The remaining \$300 of his unearned income is "net unearned income" and will be taxed at Melody's highest marginal rate. The remaining \$450 of Kyle's standard deduction ($\$1,300 - \850) is allocated to his \$1,000 of earned income. The remaining \$550 of his earned income ($\$1,000 - \450) is subject to taxation and will be taxed at Kyle's marginal rate.

DUE DATES FOR FILING INCOME TAX RETURNS

Objective 4-5

Tax returns other than returns of a corporation are generally due on or before the fifteenth day of the fourth month following the close of the taxable year. Taxpayers whose tax year is the calendar year (including almost all individual taxpayers) are therefore required to file tax returns by April 15. Individuals can receive an automatic 6-month extension by filing Form 4868 on or before the due date. However, this is an extension of the due date for filing a return and not an extension of the time for payment of tax. Therefore any tax due with the return should be paid with Form 4868 to avoid interest and penalty charges.

Corporations are generally required to file returns on or before the fifteenth day of the third month following the close of the taxable year. Corporations file Form 1120 (1120-S for S corporations). Therefore a corporation using the calendar year as its tax year would be required to file its return by March 15. However, some corporations may have a tax year that operates on a 12-month period other than the calendar year. For example, the tax year might begin on April 1 and end on March 31. If so, the corporation's return would be due on June 15.

CHAPTER REVIEW

Key Terms

adjusted gross income (AGI)

above-the-line deductions

below-the-line deductions

taxable income

kiddie tax

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [4-3] at the end of a question means that the question is based on learning objective 4-3. If there are multiple objectives, they are all listed.

1. a. What is “adjusted gross income”? [4-1]
b. List several items that are deductible from gross income in determining adjusted gross income. [4-1]
2. What is the standard deduction and how is it used? [4-2]
3. Explain how the standard deduction available to a taxpayer who is the dependent of another taxpayer is limited. [4-2]
4. Explain the additional amounts that increase the standard deduction for aged and blind taxpayers. [4-2]
5. a. Explain how a taxpayer’s itemized deductions may be limited or phased out when the taxpayer’s adjusted gross income exceeds a certain level. [4-2]
b. What itemized deductions are *not* subject to the phaseout rule? [4-2]
6. a. How is the personal exemption amount determined each year? [4-2]
b. Does the fact that a taxpayer is the dependent of another for tax purposes affect the availability of a personal exemption? Explain. [4-2]
7. a. Explain how a dependency exemption is treated on a tax return. [4-2]
b. Who may a taxpayer claim as a dependent for tax purposes? [4-2]
8. Describe the “tie-breakers” that determine what taxpayer is entitled to claim a dependency exemption for an individual. [4-2]
9. Explain how a taxpayer’s personal and dependency exemptions may be phased out when the taxpayer’s adjusted gross income exceeds a certain level. [4-2]
10. Explain how phaseout rules can combine to change the effective marginal tax rates of individual taxpayers. [4-2]

11. Explain the rules for divorced and separated parents with regard to the dependency exemption. [4-2]
12. How many basic federal income tax rates are there? [4-3]
13. What are the five different filing statuses for taxpayers other than corporations? [4-3]
14. What is the general rule regarding the liability of spouses for payment of tax due with respect to a joint return? [4-3]
15.
 - a. Explain the rules for filing a tax return as a “surviving spouse.” [4-3]
 - b. For how many years may this category be claimed? [4-3]
16. How may a taxpayer qualify under the category of “head of household”? [4-3]
17. What tax-avoidance technique is the kiddie tax designed to prevent? [4-4]
18. Explain the mechanics of the kiddie tax. [4-4]
19. Does the kiddie tax generally apply to income generated by assets gifted to a child by his or her grandparents? Explain. [4-4]
20. What is the due date for filing individual income tax returns? [4-5]

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